COMPANY RESEARCH AND ANALYSIS REPORT

USEN-NEXT HOLDINGS Co., Ltd.

9418

Tokyo Stock Exchange First Section

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Index

Summary

Leveraging the merger to create group synergies and realize medium-term growth

USEN-NEXT HOLDINGS Co., Ltd. <9418> (referred to below as "the Company") provides products and services including support tools and solutions, starting with a music distribution service, USEN Denki, an electricity service provided through a business tie-up with Tokyo Electric, and other services, to stores and other customers through subsidiaries. The Company also provides U-NEXT, a flat-rate video distribution service to consumers. USEN and U-NEXT were previously separate from one another, but the two companies were reintegrated in December 2017. The integration aims to create group synergies from cross-selling the mainstay products of group companies by mutually utilizing their strengths, including music and video content, network infrastructure, and customer base, at a higher level, and collaborating in their respective sales channels. The ultimate aim is to maximize sales per customer. Another goal of the integration is to smoothly direct cash from the high-income music distribution business to high-growth businesses such as store operation solutions, energy, and content distribution.

The Company has six business segments: store services, communications, business systems, content distribution, energy, and media. The store services business provides music distribution services to restaurants and other stores, manages music copyrights, and provides store IoT and other store operation solution services. The energy and media businesses provide such customers with sales of electricity and gas, as well as services like Hitosara that use media to help attract customers. The communications business provides communication lines to facilities and mobile communication (MVNO) services to individuals, as well as agent sales of Internet services provided by communications service providers. The business systems segment provides automated payment systems and front desk management systems to hotels, hospitals, and golf courses, among other users. The content distribution business distributes video, e-books, and other digital content to individuals.

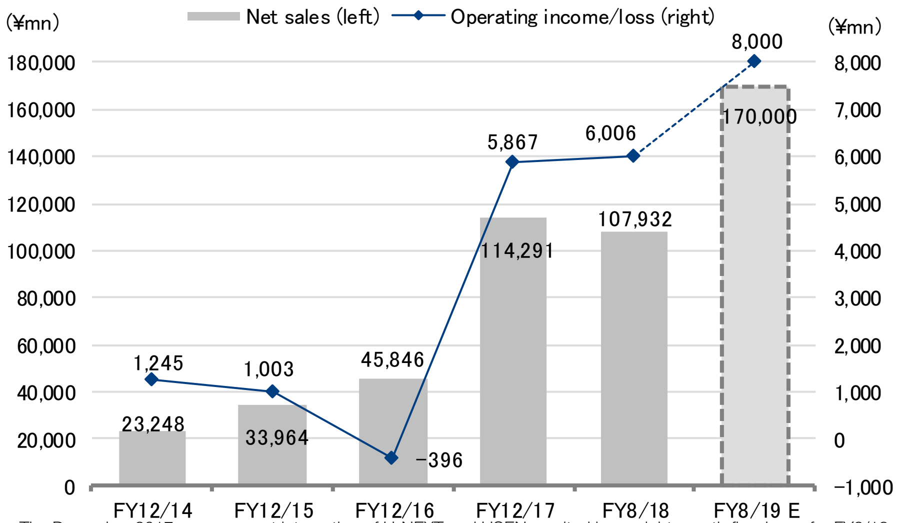
Financial results in FY8/18 were ¥107,932mn in net sales, and ¥6,006mn in operating income. The fiscal period covers only eight months, so no comparison can be made with the previous fiscal year, but operating income was ¥506mn higher than the initial forecast. This positive result is attributable to efforts to strengthen existing businesses, moves to bolster the high-growth energy business, and aggressive efforts to increase average revenue per user (ARPU) using IoT products and services for stores. FY8/19 forecast calls for ¥170,000mn in net sales and ¥8,000mn in operating income. The operating income outlook may appear a bit low, but this is because from FY8/19 the Company will have operating SG&A expenses targeting future earnings.

Using the stable, high-income business of music distribution to stores as a base, the Company's medium-term growth will likely be driven by the video-on-demand, energy, store IoT, and business systems businesses. The merger has also increased the efficiency of cash management, so the fact that cash will now be more optimally allocated to each business will be another factor behind future growth. While there may be up-front costs (investments) targeting business growth and expansion of high-growth, low-gross-margin businesses leading to a decline in profit margin, operating income should steadily grow and expand, and we expect operating income in FY8/22 to exceed ¥10,000mn. With respect to the medium-term management plan, it appears that the Company will formulate the plan while examining the progress made on the merger and new businesses. We expect the medium-term management plan to be announced in the not so distant future.

Key Points

- The integration of U-NEXT and USEN aims to maximize sales per customer
- There will be up-front costs in FY8/19 related to creating integration synergies and preparations in high-growth areas
- The stable, high-income music distribution business will be used as a base from which to return cash to high-growth businesses in pursuit of growth

Results trends



Note: The December 2017 management integration of U-NEXT and USEN resulted in an eight-month fiscal year for FY8/18. For USEN, the FY12/17 fiscal period covered the nine-month period (March 2017–November 2017), while FY12/18 covers the nine-month period from December 2017 through August 2018. For FY12/16 and earlier periods, the figures are for U-NEXT prior to the integration.
Source: Prepared by FISCO from the Company's financial results

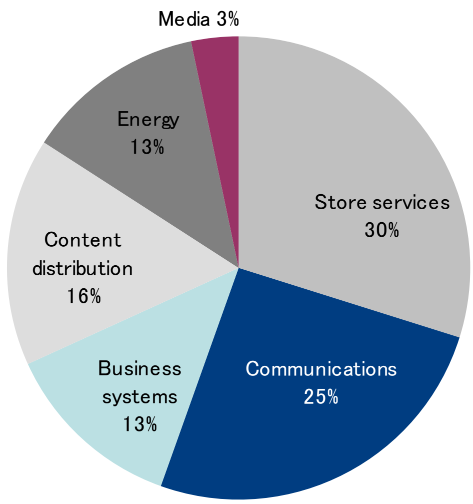
Company profile

Engaged in store support and video distribution services with music distribution business at the core

1. Company profile

The Company is a holding company that provides music distribution services (the founding business), a flat-rate video distribution service, and store and facility assistance tools and solutions via subsidiaries. The Company has six business segments: store services, communications, business systems, content distribution, energy, and media. The store services business provides music distribution services to restaurants and other stores, engages in sales and installation of distribution equipment, manages music copyrights, and provides store IoT and other store operation solution services. The energy and media businesses provide such customers with sales of electricity and gas, as well as services like Hitosara that use media to help attract customers. The communications business provides communication lines to facilities and mobile communication (MVNO) services to individuals, as well as agent sales of Internet services provided by communications providers, along with other services. The business systems business provides automated payment systems and front desk management systems to hotels, hospitals, and other customers. The content distribution business distributes video, e-books, and other digital content to individuals.

PERCENTAGE OF NET SALES IN FY8/18



Note: FY8/18 is eight months.
Source: Prepared by FISCO from the Company's financial results

Pursued digitalization and diversification from the founding business of music distribution

2. History

Mototada Uno founded USEN in 1961 as Osaka Yusen Broadcasting and subsequently built a wired broadcast network nationwide. When Yasuhide Uno took over as President in 1998, he promoted store assistance services and broadband service using the Company's existing customer base and infrastructure, and pursued diversification and digitalization, including video distribution, electronic books, and other content provision services. U's Broad Communications (now, U-NEXT), a broadband service provider that was established as a spin-off from U's Marketing, a USEN subsidiary, took over the TV paid video distribution service and sales agent business for personal optical lines and other communication lines through a corporate split-off from USEN in December 2010. In December 2017, the Company decided to reintegrate USEN and U-NEXT in order to more effectively leverage the group's strengths, such as the customer base, sales channels, and store assistance know-how of both companies.

History

Date	Event
June 1961	Mototada Uno began two-channel wired music broadcasts on 2P cable as Osaka Yusen Broadcasting
October 1987	Started multi 440 channel stereo wired music broadcasts
July 1998	Yasuhide Uno became Representative Director and President
April 2000	Changed the company name to USEN Broad Networks Co., Ltd. and moved the headquarters to Nagatacho, Chiyoda ward (Tokyo)
March 2001	Began optical fiber broadband service in portions of Tokyo's Setagaya and Shibuya wards
April 2001	USEN listed shares on the OSE (Osaka Securities Exchange) Nasdaq Japan Market (now, the TSE (Tokyo Securities Exchange) JASDAQ market)
October 2006	Acquired ALEMX INC. as a wholly-owned subsidiary through an exchange of shares
October 2006	Acquired Gaga Communications Corporation (now, GAGA CORPORATION) as a wholly-owned subsidiary through an exchange of shares
June 2007	Began GyaO NEXT (now, U-NEXT), a video distribution service for TVs
April 2009	Transferred 51% of outstanding shares of GyaO Corporation to Yahoo Japan Corporation
July 2009	Transferred all shares of Gaga Communications (now, GAGA) to T.Y. Limited, Inc. and KINOSHITA MANAGEMENT CO., LTD.
December 2010	U-NEXT; separated the "U-NEXT business and personal optical line and other sales agent business" from USEN using an absorption-type split
July 2012	Changed the gourmet information site brand to Hitosara
August 2012	U-NEXT started multi-device video distribution service
July 2013	USEN listed shares on the TSE JASDAQ market due to the TSE and OSE market merger
September 2013	U-NEXT began sales of "U-mobile * d," an LTE mobile data communication service under its own brand
December 2013	Began provision of "USEN on Smartphone" flat-rate music distribution service for smartphones (now, SMART USEN)
April 2014	U-NEXT started "BookPlace for U-NEXT," a membership e-bookstore
October 2014	Opened U-NEXT Store, a store to test and purchase U-NEXT and U-mobile service and low-cost smartphones, in Minami Aoyama
December 2014	U-NEXT listed shares on the TSE Mothers Market
February 2015	Began provision of OTORAKU, a store background music distribution service, through collaboration with RecoChoku Co., Ltd.
July 2015	Began provision of OTORAKU, a store BGM distribution service, through collaboration with RecoChoku Co., Ltd.
October 2015	Implemented a major overhaul of the U-NEXT service site
November 2015	USEN's consolidated subsidiary ALMEX formed a capital and business alliance with Unirobot Corporation
November 2015	USEN reached a fundamental agreement on a business alliance with Tokyo Electric Power Company
December 2015	U-NEXT changed its listing to the first section of TSE
July 2017	Extraordinary general shareholder meetings for the two companies approved the final contract on the merger
December 2017	Changed the company name to USEN-NEXT HOLDINGS Co., Ltd. through the merger of U-NEXT and USEN
June 2018	Established an alliance with Lakala, a leading Chinese e-payment platform operator, introduced Alipay and WeChat Pay
August 2018	Concluded a business alliance with Recruit Co., Ltd. in the field of total solutions for stores
October 2018	Made CANSYSTEM CO., LTD., the No.2 player in the store music distribution industry, a wholly-owned subsidiary

Source: Prepared by FISCO from the Company's website

Effective use of the group’s management resources through the management integration

3. Merger and creation of a holding company

The Company was established as a holding company through the management integration of U-NEXT (surviving company) and USEN. The integration aims to create group synergies from cross-selling mainstay products of group companies by mutually utilizing their strengths, including music and video content, network infrastructure, and customer bases, at a higher level, and collaborating in their respective sales channels. It also aims to realize dynamic growth strategies as a new corporate group possessing abilities in IoT, AI, and other next-generation technologies. Furthermore, the merger should result in higher operational efficiency by reducing overlapping costs incurred by individual group companies through consolidating group functions. With the aim of further bolstering such synergies, the Company reorganized its consolidated business segments into six segments: store services, communications, business systems, content distribution, energy, and media.

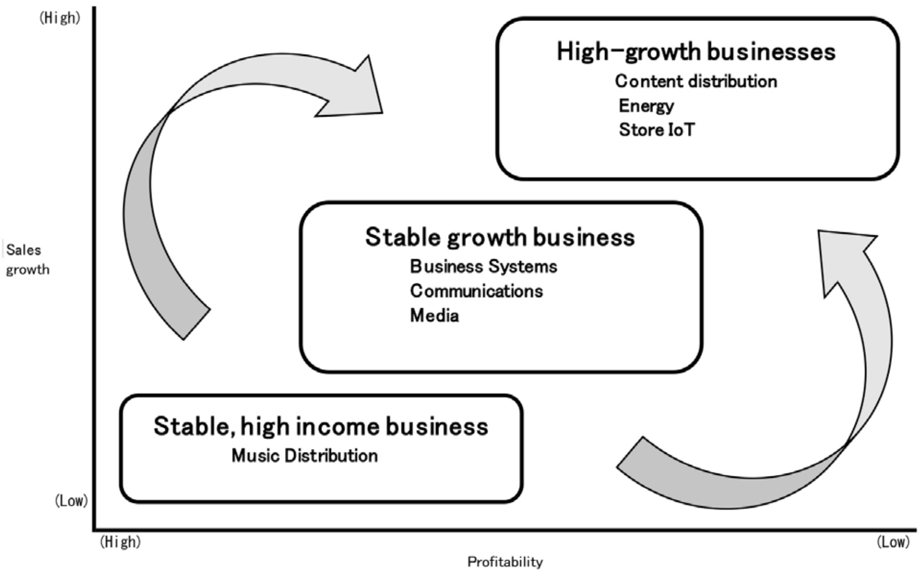
Group businesses and subsidiaries

New segment	Subsidiary	Role	Former segment
Store services	USEN	Operation and sales of wired broadcasts and digital music broadcasts and sales of store system solutions	Music distribution
	U’S MUSIC	Management and development of music copyrights	Others
	USEN Techno-Service	Electrical and communication facility installation consignments, and various equipment and information & communication terminal refurbishing and kitting	Others
Communications	USEN NETWORKS	Agent sales of communication lines, etc.	Communication network
	U-NEXT	Video distribution service for individuals and content platform operation and sales	Communication network
	USEN ICT Solutions	Corporate line sales	ICT services
	USEN-NEXT LIVING PARTNERS	Agent sales of communication lines, etc.	Communication network
	U-MX	Agent sales of communication lines, etc.	Communication network
	Next Innovation	Agent sales of communication lines, etc.	Communication network
	Y.U-mobile	Provision and sales of MVNO service for individuals	Communication network
	minimini-NEXT (equity-method affiliate)	Agent sales of communication lines, etc.	Communication network
Business systems	ALMEX	Development, production, and sales of automated payment systems, etc. to hotels, hospitals, and golf courses	Business systems
Content distribution	U-NEXT	Video distribution service for individuals and content platform operation and sales	Content platform
	U-NEXT MARKETING	Call center and AI business	Content platform
Energy	USEN	Provision of high- and low-voltage electricity to stores and retail facilities	Others
Media	USEN Media	Customer-drawing support business	Others
Others	U-NEXT MARKETING	Call center operations business	Communication network
	6 other companies (3 non-consolidated subsidiaries, 3 non-equity-method affiliates)		

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

From the standpoint of growth potential, the Company sees music distribution as a stable, high-income business; business systems, communications, and media as stable growth businesses; and content distribution, energy, and store IoT as high-growth businesses. Another key goal of the integration is more efficient cash management by directing cash earned in the stable, high-income business to high-growth businesses. The Company hopes to aggressively utilize the group’s telemarketing and agent sales capabilities to bolster its provision of IoT services and energy sales, as well as customer-drawing support and other store solution services to its strong customer base in the music distribution service. In this way, the Company is ultimately aiming to maximize sales per customer by effectively utilizing its customer base, products and cash within the group.

Business classification by growth stage



Source: Prepared by FISCO from interviews

Business overview

Promoting cross-selling with stable, high-income music distribution as a base

1. Store services

The store services business is divided into the music distribution business and the store operation solutions business. The music distribution business has been operating for more than 50 years, and provides the USEN service for broadcasting music and information to stores, offices, and homes nationwide. Naturally, the Company properly handles copyright issues for all of the music it supplies. Users rent service tuners from the Company, and the tuners utilize dedicated coaxial cable, communications satellite, or

Internet line infrastructure as appropriate for the tuner installation environment. Stores comprise the vast majority of customers, with restaurants, retailers, beauty salons, and health clinics accounting for a high percentage of users. Chain store users range from national chains to chains focused on local areas. This business also provides store operation solutions on a one-stop basis, with coverage from opening assistance to business environment creation and sales promotions. In store operation solutions services, the Company's offerings include USEN Register, a tablet POS register, Store Assurance Insurance, a casualty insurance covering store risks, USEN PAYGATE, a cashless payment system for stores, UPLink, a store app creation service, USEN SPOT, a Wi-Fi service for stores, and many other services. The Company currently adding even more services.

(1) Music distribution business

This business has a strong customer base of 620,000 users and generates steady sales. The Company holds an overwhelming share of about 80% in store and facility background music. Profitability is high too, and this business generates cash that supports the group strategy. It is a stable, high-income business. Key attributes underpinning the robust customer base are more than 500 channels and excellent quality. The service offers specialty channels, such as J-POP, Western music, jazz, relaxing music, and classical music, as well as channels that support song requests and meets the music needs of all store environments. Furthermore, sound quality applies optimal acoustic pressure adjustment for use as background music in association with all broadcast songs. The group has extensive support operations with 150 branches nationwide, 1,000 salespeople, and 750 engineers. This gives it the ability to cover services from installations to aftercare. We think the deep-rooted popularity of this service makes sense with its robust music lineup, quality, and support capabilities and provision of CD players and other hardware, continuous software purchase costs, software renewals and song selection, and time-consuming copyright processing at a monthly fee of ¥4,000-5,000.

Besides ordinary music distribution, this business also covers office background music that is refreshing and relaxing and lets people know when office hours are ending, customized broadcasts that address the unique needs of chain operators, and alliances with overseas background music companies, and personal and home music distribution service. Additionally, it offers OTORAKU service with trouble-free installation. This is a background music app for making customized playlist that can be used at stores and other commercial facilities. The app naturally covers major domestic music labels and even extends to overseas independents, distributing a rich genre of songs from pops to easy listening. If the user has sufficient IT literacy to operate a tablet, the app facilitates customization of a playlist suited to the store environment and many playlists prepared by professionals that cover a range from standard songs to seasonal choices and popular rankings.

It has been estimated that slightly less than 2 million stores and other commercial sites use background music out of a market with 3 million sites, and that more than half of these sites are not able to deal with copyright issues. Amid growing global awareness of intellectual property, the Japanese Society for Rights of Authors, Composers and Publishers (JASRAC) has adopted a more rigorous stance toward stores that have not complied with procedures and is taking actions against more locations. The Company promotes awareness to non-compliant stores along with JASRAC, and these activities are boosting recognition of improper use and the need for compliance with copyright procedures at stores. If this trend continues, non-compliant stores might offer opportunities as new customers in the future. We think this stable business has growth potential given this situation.

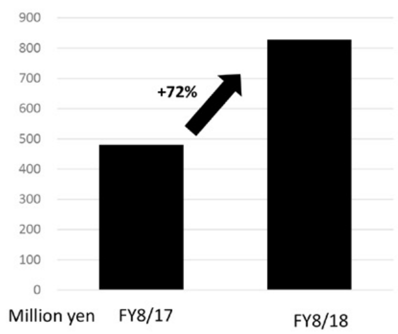
In October 2018, the Company converted CANSYSTEM CO., LTD., the No.2 player in the store music distribution industry into a wholly-owned subsidiary, with a plan to consolidate CANSYSTEM in January 2019. CANSYSTEM has 130,000 customers, net sales exceeding ¥5,000mn, and operating income of ¥400mn. When the two companies merge, the Company's customer count will reach around 750,000 customers. By turning CANSYSTEM into a subsidiary, in addition to effectively utilizing one another's customer assets and strengthening the store operation solution services that both companies have been engaged in, there should be a pickup in measures to deal with stores that illegally use services without paying copyright fees. Meanwhile, on top of efficiencies created through the sharing of telegraph poles, audio sources, radio waves, and regional offices, by sharing accumulated knowledge and knowhow from their respective provision of services to the store market for over 50 years, there should be an acceleration in the development of new products and services, and increased corporate value.

(2) Store operation solutions

The Company's customers, who were cultivated over many years through the music distribution business, and who serve as the foundation of the Company's business, currently have stronger needs for store operation solutions than music distribution. Many stores are self-run, standalone stores or smaller chains that lack the scale benefits of national chains. The shift to IT has progressed in the retail and service sectors in recent years, and this trend has made the business environment even more challenging for small and super-small stores. To help such stores, the Company provides service with one-stop delivery of cutting-edge equipment and systems that small and super-small stores find it difficult to deploy on their own, and this service is growing in popularity. This service is a way for the Company to improve customer satisfaction and raise average customer spending because it involves the supply of products and services besides music distribution. Therefore, the store operation solutions business has been positioned as a high-growth business, and the Company is taking an aggressive approach to sales. With the merger, the Company is now able to more efficiently provide the group's products and services to the long-term customer base.

Of these solutions, USEN Register, which is a tablet POS register and ordering system that uses handy devices, is a particularly popular solution. Key attributes driving this appeal are multi-functionality that allows for automated sales compilation, analysis, and management, low-cost, iPad-enabled operability with a stylish design and intuitive features, and year-round support through 150 locations. USEN Register also has a broad range of other service content, such as building reservation and payment systems and total arrangement and installation of infrastructure and equipment needed to start business and open stores. The Company has also started to offer U-Order, an inexpensive self-order portal specializing in all-you-can-eat and all-you-can-drink service where no connection to the register is necessary as well as calls for server assistance, thereby expanding the scope of self-order portals, which can be expensive to install. The Company already offers USEN PAYGATE, a credit card payment device, and is expected to begin introducing Alipay and WeChat Pay based on the business alliance with Chinese company Lakala.

Growth in tablet POS register net sales
USEN's concept for dividing the restaurant solutions market



Source: The Company's results briefing materials

Aiming for stable growth amid the changing environment

2. Communications

The communications business provides USEN GATE 02, an ICT solution for businesses, USEN Hikari, a broadband Internet line for businesses, U-mobile, an MVNO service for individuals, and U-NEXT Hikari 01, a broadband Internet line for individuals. The ICT business sells a variety ICT products and services, including USEN GATE 02 Internet line, dedicated lines, and other corporate network services, cloud services from Google, Cybozu Inc. <4776> and others, data communications and mobile device management (MDM) services, and data center services. The Company was the first provider worldwide to offer Internet connection service from optical fiber and has provided services to more than 40,000 companies in the constantly changing and advancing ICT industry. We think the breadth of the service lineup is an important strength in this business. The business handles all network environment-related needs while offering an integrated contact point providing a high level of convenience. With the evolution and expansion of ICT, all things connect to the Internet, and the purpose of purchasing products is shifting from ownership to usage, and there has been a rise in the sharing economy and in the consumption of services. Additionally, amid the changes in lifestyle due to working style reforms, there is now a need to maintain and improve labor productivity. New technologies, such as the cloud, AI, VR, and 5G are emerging and being incorporated into society, so it is more essential than ever before to use technology in a variety of contexts. If small- and medium-sized stores fail to incorporate such technologies, they could lose ground and might never catch up.

In the Internet line sales agent service, the service mainly promotes sales of FLET'S optical lines provided by NTT East Corporation and NTT West Corporation, and receives sales commissions based on the number of lines sold. The Company has used this income to expand the agency network nationwide. U-mobile, an MVNO service, uses communication lines from NTT DOCOMO <9437> and SoftBank (SoftBank <9984> group) and sells lower-priced smartphones and SIM cards to individual customers. It sets monthly usage fees at a cheaper level than the services supplied by existing major mobile phone companies, and mainly sells service through big-box electronics stores and online. While this was a relatively lucrative business in the past years, this has become a tough business now due to system changes, offensive moves by large carriers, and an increase in the number of competitors. Nevertheless, the agency network is an important management resource for the Company, with its aims of expanding the customer base and enhancing cross-selling. In addition to line sales, the Company has started to use these agencies as a powerful tool to sell store solutions and for other growing businesses. For the Company, doing so enhances its sales capability, while for agencies this results in a diversification of business, so the interests of both sides align, and the relationship between the two sides is deepening into a win-win relationship.

ALMEX holds unique positions in the group and industry

3. Business systems

Subsidiary ALMEX INC. handles the business systems business. This business supplies automated payment machines and lodging facility management systems to business hotels, city hotels, and "leisure hotels," automated payment machines and automated patient check-in machines to general hospitals and other medical institutions, and automated payment machines and check-in machines to golf courses. It also sells ordering terminals and operating systems to restaurants. As a fabless manufacturer, it develops, sells, and provides maintenance for equipment and systems. ALMEX has the culture of a manufacturer, which makes it a different presence within the group. However, like the group's other businesses, ALMEX promotes a concept of providing hospitality to the customers of facilities installing its equipment through the supply of products and services leveraging IT and other cutting-edge technologies.

While automated payment machines might seem like a market segment that would be dominated by large electric equipment manufacturers, ALMEX holds very high market shares in Japan, at 85% for leisure hotels, 65% for business hotels, 65% for large medical institutions, and 70% for golf courses. The reason for this strong presence goes back to very high demand for automated payment machines during Japan's economic bubble period 30 years ago in the leisure hotel industry, which confronted labor shortages and also tried to accommodate the customer preference for avoiding face-to-face contact at the time of payment. In this environment, while leading industry players failed to capitalize on the demand out of fear over their reputations, ALMEX aggressively pursued sales as a specialty company and supplied systems that combined unique ideas, such as karaoke service, and existing technologies, and were customized for individual leisure hotels. This kind of pinpoint service was ALMEX's key to success. What differentiates ALMEX from its peers is its accumulated know-how in automated payment machines and related reception operations in a variety of markets.

ALMEX has a low-volatility, highly profitable business model based on a number of factors, including being a fabless manufacturer, periodic equipment replacement demand in conjunction with renovations at existing customer locations, and recurring income from maintenance and other services accounting for just under 50% of sales. Labor savings is already needed nationwide and in all industries because of the decline in Japan's working population. The hotel sector is likely to be a market where demand for ALMEX's products will grow because of the construction rush as well as the pickup in renovations by leisure hotels targeting inbound demand ahead of the Tokyo Olympics and Paralympics. Furthermore, with the aim of directly capitalizing on growth opportunities from inbound and outbound business, ALMEX has started offering multi-lingual support in existing products and services, and is operating a leisure hotel website for foreigners visiting Japan. ALMEX is also cultivating the market in Southeast Asia through a local subsidiary established in Malaysia in 2014.

Superiority in the growing video distribution business

4. Content distribution

U-NEXT provides video distribution (video-on-demand; VOD) service. This service charges a monthly fee to individuals for viewing access by television (either through a set-top box connection or Internet connection), PC, smartphone, tablet, or other devices of video content (movies shown at theaters and dramas, animated programs and variety programs aired on televisions), electronic book content (novels, comics, magazines, photograph collections, and others), and music content (Japanese music, Western music, classical music, enka songs, and others). It offers unlimited viewing of mainly older content and pay-per-view access to quasi-new and new works.

Leading companies in the flat-rate video distribution market are dTV, Hulu, the Company (U-NEXT), Amazon (Prime Video), and Netflix. Services include dTV, which is operated by NTT DOCOMO, with access to more than 120,000 content items at a fee of ¥500 per month (tax-excluded price; same below), Hulu, a subsidiary of Nippon Television Holdings Inc. <9404>, with over 50,000 items at a fee of ¥933, Prime Video, which is run by US-based Amazon with over 32,000 items at a fee of ¥370 (plus the ¥3,611 Prime annual members fee), and US-based Netflix, with 30,000 items at fees of ¥800, ¥1,200, and ¥1,800 per month depending on image quality. Amazon Prime Video and Netflix stand out in proprietary overseas content, dTV has many short content items for smartphones with less image quality, and Hulu carries many overseas dramas and domestic TV programs aired on the NTV network. Amazon Prime Video and Netflix appear to be growing thanks to sales promotions leveraging their capital resources.

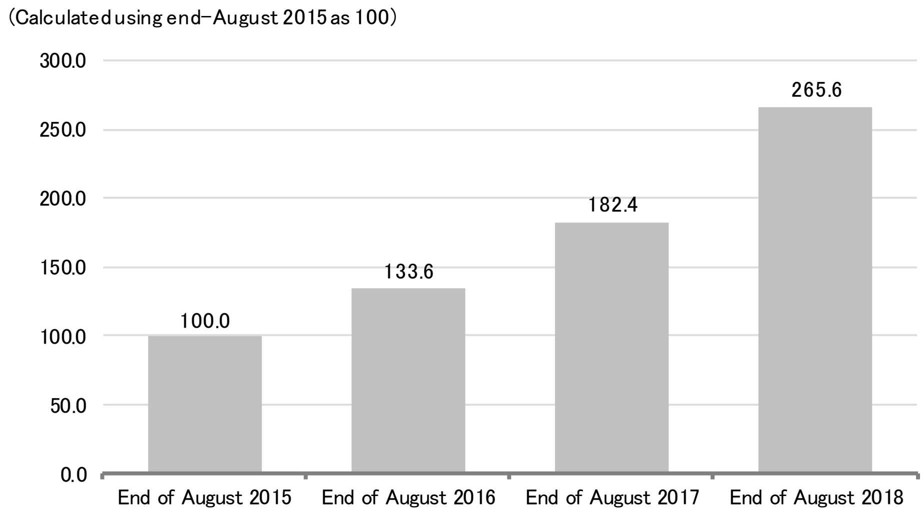
The Company, meanwhile, charges ¥1,990 per month. While this may seem expensive at first glance, its service is achieving rapid growth in the market. The main reason is an advantage in content. Users have unlimited access to more than 65,000 content items, such as movies and TV programs and can select from over 45,000 rental items. Though a fee is charged, there is also a robust lineup of the latest works that have just been released or aired. The service allocates 1,200 points on the 1st of each month, thereby enabling effectively free access to the latest pay items within the point range. It is also the only major service that carries adult content. The overwhelming victory by TSUTAYA Co., Ltd. over US-based major Blockbuster LLC, which entered Japan, during the growth years in rental videos, highlights the importance of adult content in expanding content demand.

The Company also has an extensive lineup of animated programs and Korean dramas and is making inroads with "geeks" and women. It offers family-oriented major content from Disney and others too and includes a service for unlimited reading of more than 70 magazines. Points mentioned earlier can be used to purchase books and comics and receive discounts on movie tickets. Family accounts allow for simultaneous viewing by up to four people, and the privacy of each viewer is protected by security. This effectively works out to about ¥500 per month per individual viewer, a relatively cheap price. We think the Company is best positioned to serve as a replacement for rental videos.

The main issue is capital resources. While this is not the one and only factor that absolutely determines success in the video distribution business, content procurement and sales promotions require a certain amount of funds. The two US-funded companies have leveraged capital resources to recruit customers, despite mixed reviews since much of their content is not geared to Japanese people. Amazon Prime Video could be called essentially free due to its inclusion as a benefit of Amazon Prime membership. Netflix invests heavily in its own content. These two companies frequently run high-priced TV commercials. Given these conditions, the Company has been steadily adding users each month by utilizing sales via the Internet, at agents, and at movie theater booths and listing and affiliate advertisements and promoting its advantage in contents.

The Company stands out in business initiatives by building alliances with a variety of companies. It works with companies that have large customer base in communications, distribution, and real estate industries, including Yamada Denki Co., LTD. <9831> and TSUTAYA, through provision of service in an OEM format. Other services include "Anime Unlimited," an animated program app promoted with SoftBank, and video distribution services available for registration by fan club members only, such as EXILE TRIBE FAMILY. As a result, the number of U-NEXT subscribers has risen 2.6-fold over three years, and increased 46% YoY at the end of August 2018. The flat-rate video distribution service reportedly had a market size of ¥138.3bn in 2017 (+13% YoY), and the Company now holds the No.3 share at 12.6%, up 0.3 of a percentage point. This is a high-growth mainstay business for the Company.

Growth rate in U-NEXT subscribers



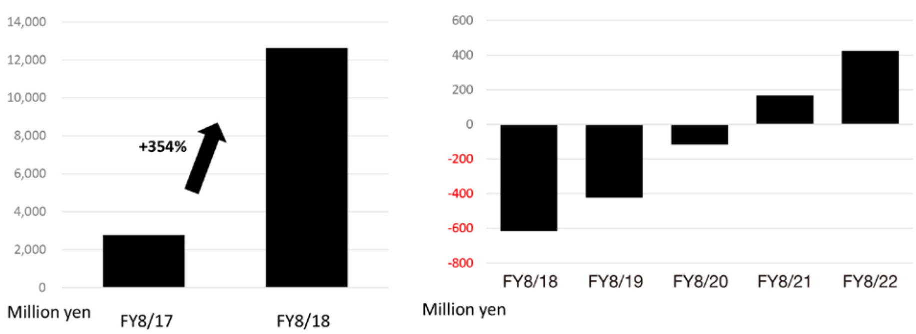
Source: Prepared by FISCO from the Company's website

Viewed as a fast-growth area offering a hook for cross-selling other services

5. Energy

In the energy business, the Company has a business alliance with Tokyo Electric Power Company Holdings, Inc. <9501>. Based on this business alliance, the Company sells high- and low-voltage electricity as well as city gas to stores and retail facilities located outside of Tokyo Electric Power Company Holdings' service territory, and also offers consulting services such as proposals of energy-conservation measures. This business was just recently launched in September 2016 following the liberalization of electricity sales, but the Company continues to see a rapid increase in the number of subscribers, as the Company is engaging in sales by promoting its low prices to its deep customer base. Gross margin in the energy business is low, and this will reduce the Company's operating margin over the medium term, but because it enables sales to stores and other customers that did not need background music, the Company is positioning the energy business as a high-growth business that offers a hook for cross-selling store operation solutions and other services, and the Company is aggressively working to expand sales. The energy business is currently posting losses, but the Company expects it to become profitable in FY8/21.

USEN Denki sales and profit growth (right)



Source: The Company's results briefing materials

Offering restaurant information websites to help attract customers

6. Media

The core product in the media business is Hitosara, a gourmet restaurant information website that helps restaurants attract customers. The site focuses on chefs (Hito) and food (Sara), and offers new appeals for restaurants. Also, by narrowing its scope to relatively high-end restaurants, it differentiates itself from its competitors, such as Hot Pepper Gourmet and Gurunavi. Hitosara has established a considerable market position and has grown to more than 20mn UUs per month. In addition, the Company has added an immediate reservation function to Hitosara, thereby expanding the business scope by adding a transaction model from on-the-spot reservations to the existing advertising revenue business model. Meanwhile, as a Tabelog agent, it also proposes efficient ways to attract customers using different media mixes. Other sites include SAVOR JAPAN, a multi-lingual version of Hitosara that targets foreigners visiting Japan as an inbound strategy with English, simplified Chinese characters, traditional Chinese characters, and Korean language support. The media business also offers WeColle, a wedding media that targets women who are beginning to think about marriage using a four-pronged strategy (free magazine, Internet, events, and salons), as well as “bangs,” a web magazine for finding hair and other stylists.

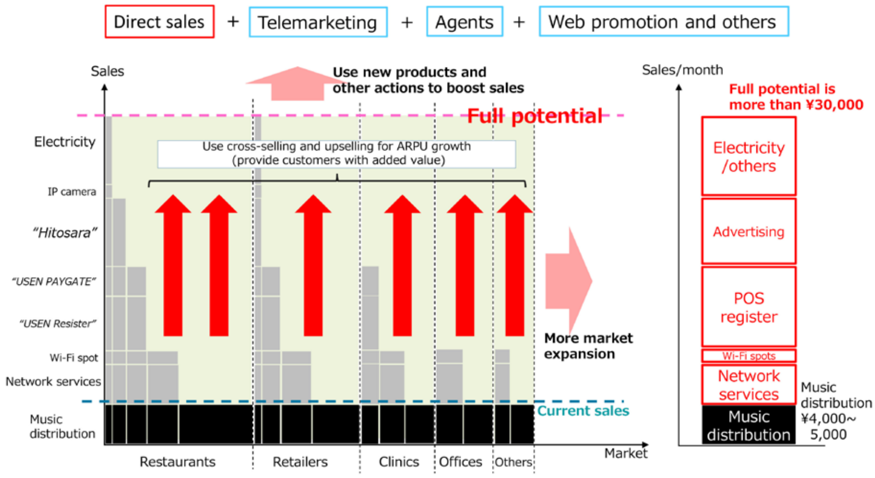
Financial results trends

The group’s assets are its robust customer base and nationwide sales abilities

1. Effective use of the group’s assets

The diagram below illustrates cross-selling, which was a key aim of the Company’s merger. With cross-selling, the Company will provide the optimal solution services to meet the needs and wants of its strong customer base which it has built up through the music distribution business. This entails effectively utilizing the operating assets of group companies, including direct sales, telemarketing, and agent sales, to provide music and video content, electricity, tablet POS registers and cashless payment terminals, and casualty insurance to stores, among others. There is still room for growth in both the customer base, which is the Company’s business base, as well as its products, which are the assets of each group company.

Effective use of the group's assets



Source: The Company's results briefing materials

Aggressive management immediately following the merger

2. FY8/18 results

Financial results in FY8/18 were ¥107,932mn in net sales, ¥6,006mn in operating income, ¥5,012mn in ordinary income, in ¥3,169mn in profit attributable to owners of parent. The fiscal period covers only eight months, so no comparison can be made with the previous fiscal year, but net sales were generally on target with the initial forecast, while operating income, ordinary income, and profit attributable to owners of parent were respectively ¥506mn, ¥512mn, and ¥1,469mn above the forecast.

FY8/18 results

	FY12/17 (¥mn)	% of net sales	FY8/18 (¥mn)	% of net sales	Change (%)
Net sales	114,291	100.0	107,932	100.0	-
Operating income	5,867	5.1	6,006	5.6	-
Ordinary income	3,303	2.9	5,012	4.6	-
Profit attributable to owners of parent	427	0.4	3,169	2.9	-

Note: FY8/18 is eight months.
Source: Prepared by FISCO from the Company's financial results

USEN group's fiscal periods

	FY12/17 cumulative 3Q	FY12/17 full year	FY8/18 1Q	FY8/18 full year	FY8/19 full year
Former U-NEXT	January-September	January-December	January-March	January-August (8 months)	September-August (12 months)
Former USEN	March-August (6 months)	March-November (9 months)	December-February (3 months)	December-August (9 months)	September-August (12 months)

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

In addition to bolstering existing businesses, strengthening efforts in the high-growth energy business, as well as proactively enhancing the lineup of services to stores, starting with IoT products and services, were the factors for success. Specifically, the Company began retail sales of electricity and started handling casualty insurance to comprehensively cover stores' risks, and the Company plans to start offering Alipay and WeChat Pay, two widely used e-payment services in China through a business alliance with major Chinese acquirer/platformer Lakala. In addition, the Company formed a business alliance with Recruit, and the two companies will link their respective business assistance resources and bolster efforts with the goal of improving labor productivity and increasing the use of IT in the retail sector, centered on restaurants. This alliance makes it possible to supply one-stop solutions that help a store with all of its issues, from store opening preparations to store openings and activities to make the store a success.

Temporary up-front costs in FY8/19 in order to maximize merger benefits

3. FY8/19 outlook

For FY8/19, the Company is forecasting net sales of ¥170,000mn, operating income of ¥8,000mn, ordinary income of ¥6,500mn, and profit attributable to owners of parent of ¥3,000mn. No year-on-year comparisons can be made due to the fact that FY8/18 was only an eight-month period, but the operating margin is expected to be 4.7%, which is less than the 5.0-5.5% range which is considered average.

In order to fully utilize its management assets, primarily the group's customer base and products, from the current fiscal year the group is maintaining its direct sales platform while strengthening its sales channels, including telemarketing, online marketing, and its agency network. Also, to deal with the rapidly changing technological and social environment, the Company will utilize new technologies, such as the IT technologies of IoT and AI to quickly capitalize on market needs and business opportunities. As a part of this, the Company plans for there to be an increase in up-front costs in FY8/19 as it expands its sales channels and transforms its business model to set the stage for medium-term growth. Consequently, the forecast operating margin for FY8/19 is lower than the previous fiscal year's pro-forma value, but an improvement should be seen in the following fiscal year and beyond.

FY8/19 outlook

	FY8/18 (¥mn)	% of net sales	FY8/19 forecast (¥mn)	% of net sales	Change (%)
Net sales	107,932	100.0	170,000	100.0	-
Operating income	6,006	5.6	8,000	4.7	-
Ordinary income	5,012	4.6	6,500	3.8	-
Profit attributable to owners of parent	3,169	2.9	3,000	1.8	-

Note: FY8/18 is eight months.
Source: Prepared by FISCO from the Company's results briefing materials

Medium-term management plan

Maximizing both group synergies and corporate value

1. Basic policy and management strategy

Based on a core policy of "delivering the next essential thing," and having transitioned to a holding company framework, the Company is striving to maximize shareholder value and corporate value as a corporate group that continues to be needed by society and from which much is expected by society through the creation of new value and services. To maximize group corporate value, the Company aims to maintain net sales, EBITDA, and capital spending as planned, and has set benchmarks for the equity ratio, which reflects financial balance soundness, and for ROE, which consists of a profitability indicator (net profit margin), efficiency indicator (gross capital turnover ratio), and the effectiveness of the utilization of liabilities (financial leverage), as important management indicators.

The Company's longer-term business strategy seeks to maximize group synergies, which are the primary merger goal, and improve growth potential and profitability while creating new services. Furthermore, the Company aims to quickly identify needs and business opportunities in fast-changing technology and social environments and enlist IT capabilities, such as IoT and AI. It hopes to achieve income growth through fast decision-making and pursue maximize shareholder and enterprise value. By sharing customer assets, bolstering collaboration among group companies, and promoting focus on specialized areas, the Company aims to expand the various business values in the newly classified six sectors.

Making good progress on preparations targeting medium-term profit growth

2. Medium-term profit growth scenario

Using the stable, high-income business of music distribution to stores as a base, the Company's medium-term growth will likely be driven by video-on-demand, energy, store IoT, and business systems. The merger has improved cash management efficiency, so the fact that cash will now be more optimally allocated to each business will be another factor behind future growth. While there may be up-front costs (investments) targeting business growth and expansion of high-growth, low-gross-margin businesses leading to a decline in profit margin, overall group operating income should steadily increase.

(1) Store services

With respect to the music distribution business, the Company's goal is to maintain its strong customer base and the current level of profit. While the likelihood may not be particularly high, because the Company acquired the No.2 player in the industry CANSYSTEM through M&A, we believe that there is a possibility that order will be restored in the industry, including a reduction in the number of stores illegally using music, and that the number of customers will begin to increase again. In store solutions services, the Company is strengthening its sales strategy, including adding employees and promoting sales other than direct sales, such as agencies, telemarketing, and online. Therefore, in order to add employees and boost the motivation of agents, the Company will have to pay some up-front costs in the short term. However, depending on the progress of cross-selling, such as tablet POS cash registers and small-amount, short-term insurance, there is a possibility that the increase in sales per customer will occur faster than originally expected. Moreover, changes in the industry environment, such as the shift to cashless and the shortage of labor, are occurring rapidly, and thus stores may also see a rapid increase in needs. In response to these needs, the Company has allied with Recruit to address the shift to cashless, will introduce Chinese e-payment services such as Alipay, and develop table-top self-ordering systems, and is otherwise aggressively developing products and services.

(2) Communications

Given the fact that the business environment is becoming more challenging, including the decline in commissions on agency sales of Internet lines and the entry of major carriers into inexpensive smartphone services, there is a possibility that operating margin will decline in the future until the Company is able to respond to the business structural changes. On the other hand, however, we expect the agency network to contribute to store support, including expansion of the Company's customer base and enhancement of cross-selling.

(3) Business systems

The inbound business is a tailwind for ALMEX. There appears to be an increase in renovation activity in conjunction with the increasing lodging needs of foreigners in the leisure hotel market. Also, the shortage of labor is growing more acute each year, so it appears that demand for ALMEX's automated payment machines for hotels will remain strong for the foreseeable future. ALMEX is being managed with an approach no less aggressive than the other high-growth businesses. This includes the development of lodging management systems for private-home lodges and simple accommodations, and the business alliance with Expedia Group, which operates one of the world's largest travel platforms. In addition, installation of automated check-in terminals and automated payment machines at advanced medical institutions remains solid.

(4) Content distribution

While rapidly growing Amazon and Netflix, the two largest content distributors, have a bias towards content, U-NEXT is superior in terms of new releases, and high growth in the double digits is expected to continue over the medium term. Also, a U-NEXT button has been added to the remote control for Sony's "Bravia" television, and this appears to be helping to increase subscriptions as the percentage of Internet-connected televisions continues to rise. Installing a U-NEXT button on remote controls appears to be a powerful strategy, and the Company is also looking into working with other manufacturers besides Sony on this.

(5) Energy

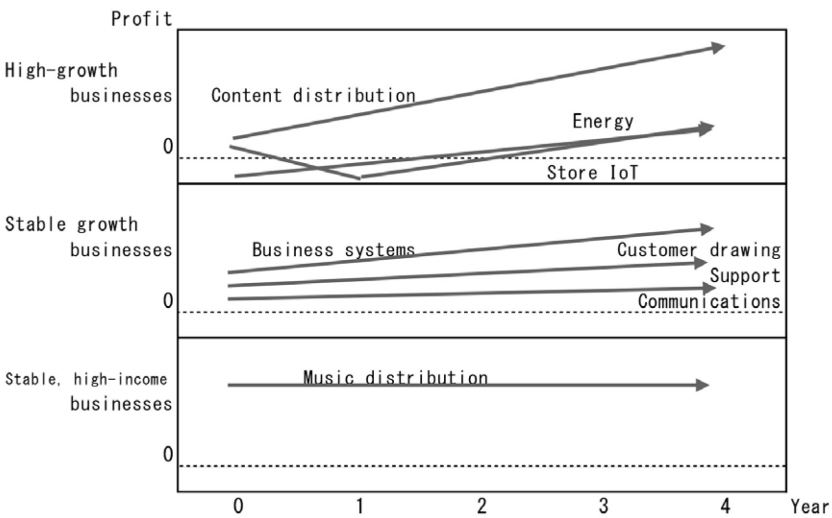
Although it just recently launched operations in September 2016, USEN Denki is seeing a steady increase in subscribers, while USENGAS just started service in October 2018. The services are being well received by the Company's customers because the Company is able to provide the electricity and gas steadily at low prices. The Company is positioning these as hook products that will help it to expand sales of other group products and services, and sales efforts are being ramped up even further. The strong start is also causing an increase in operating costs, and the business will be a loss-maker over the near term, but the Company expects the business to improve its profit by ¥1.0bn and become profitable within five years.

(6) Media

For foreigners, eating Japanese food in Japan is becoming even more of a value-added experience. Based on this trend, the strategy of proposing high-quality dining experiences to foreigners visiting Japan will likely be extremely effective over the medium term. Going forward, in addition to online media, the Company plans to also mix in events, books and other media as it aims to increase the number of overseas users, particularly in Asia, as well as domestic users.

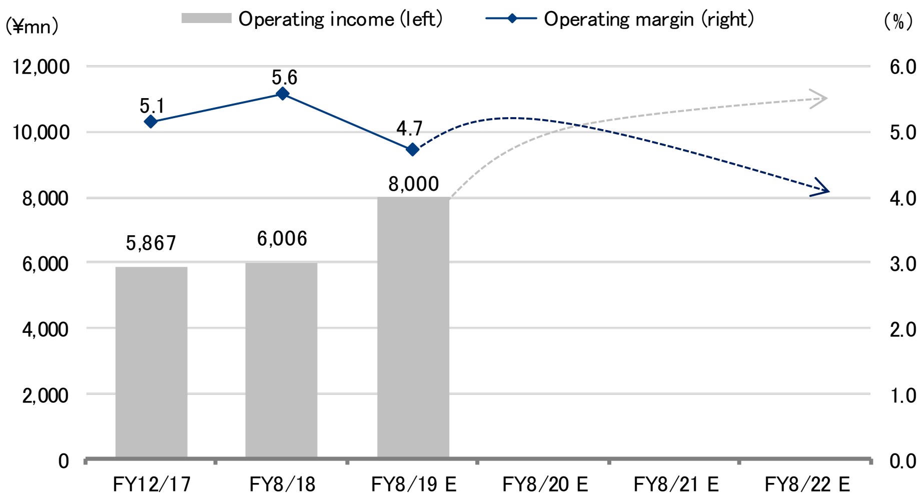
To summarize the Company's medium-term earnings trend, up-front costs will be a factor in FY8/19, and while we expect the operating margin to subsequently improve temporarily, the growth of the low margin energy business and the business model transformation of the communications business are expected to weigh on the operating margin over the medium term. Meanwhile, the energy business is expected to contribute significantly to the growth in net sales. Because we anticipate an increase in operating income growth capability, we look for the Company to record operating income exceeding ¥10,000mn in FY8/22. It appears that the Company will formulate its medium-term management plan while examining the progress made on the merger and new businesses. We expect the medium-term management plan to be announced in the not so distant future.

Medium-term growth in net sales by segment



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

Medium-term growth in operating income



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

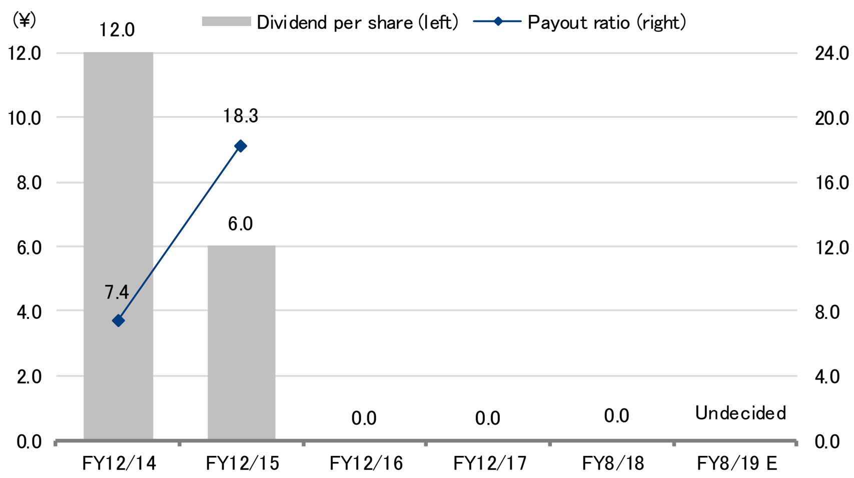
Shareholder return policy

FY8/19 dividend is undecided as focus is placed on the merger

1. Dividend policy

The Company has presented a basic policy of making decisions on allocation of surplus funds based on results and in light of comprehensive assessment of the financial position, profit-and-loss condition and the new investment plan. It also intends to pay dividends from surplus funds once a year at fiscal-year end. While the Company views return of profits to shareholders as an important policy, it decided not to pay dividends from surplus funds in FY12/17 and FY8/18 in order to strengthen the business foundation for realizing new growth via the merger and dynamically respond to business environment changes. As an extension of this, the dividend for FY8/19 is undecided (but not zero). Costs are being incurred up front, but some enhancement of the Company's profitability resulting from the merger has started to emerge, so we hope that the Company will reinstate a dividend as soon as it can.

Trends in dividend per share and payout ratio



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

Benefit program that enables U-NEXT services to be used under favorable conditions

2. Shareholder benefit program

The Company provides a benefit program to shareholders who own one unit (100 shares) or more of its stock that consists of waiving the initial fee and usage fees for 90 days in the U-NEXT video distribution service. It also gives them 1,000 points that can be used in U-NEXT service (shareholders who are already members only receive the points). Furthermore, it waives the initial fee for mobile data communication service U-mobile's calling plus plan and gives a ¥5,000 cash return via postal money order. Reception of these shareholder benefits requires registration through a dedicated URL.

Information security

Carefully managing security for work-style reforms

The Company is strengthening personal information protection capabilities and continues to implement educational programs. However, it cannot give a guarantee of complete protection and there is always risk of personal information leaks due to improper access from an external source, system trouble, insider crime, human mistakes, and management mistakes at outsourcing and service provision partners. Given these challenges, the Company manages the information system at a data center, employs a firewall, and continually assesses vulnerability in web applications as a more proactive information security effort. The Company allocates notebook PCs and smartphones to individuals as part of work-style reforms. It greatly reduces security risk by equipping notebook PCs with a security chip (TPM) and utilizing MDM in smartphones.

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