create restaurants holdings inc.

3387

Tokyo Stock Exchange First Section

23-May-2017

FISCO Ltd. Analyst
Ikuo Shibata

FISCO Ltd.
http://www.fisco.co.jp

Index

Summary

Profit lower on higher sales in FY2/17 mainly due to weaker consumption activity
Focus on solidifying the business foundation to accelerate growth from FY2/19

create restaurants holdings inc. <3387> (hereafter, also “the Company”) focuses mainly on the operation of restaurants and food courts inside shopping centers, while also developing izakaya (traditional Japanese eating and drinking establishments) and restaurant formats acquired through M&A. One characteristic is that the Company carefully selects locations that attract large numbers of customers, and employs a distinctive multi-brand, multi-location strategy, which involves developing a variety of restaurant formats attuned to specific locations (regional characteristics, customer attributes, competition status, etc.). This strategy has supported the Company’s main business. Currently, the Company has 857 restaurants in approximately 200 brands (as of end-February 2017). Moreover, the Company is achieving higher growth by engaging in “Group Federation Management,”*1 which involves incorporating brands with high growth potential into the Company’s own growth profile through M&A, such as the seafood izakaya chain “ISOMARU SUISAN”*2, that has been gaining popularity with its 24-hour operation in favorable station-front locations. In this way, the Company appears to have entered a new growth phase.

*1 Through the group management being promoted by the Company, growth is fostered by achieving a balance between “cohesion” from the holding company and “autonomy” at each group operating entity.
*2 Developed by SFP Dining Co., Ltd. <3198> that was acquired in April 2013.

The Company reported lower profits on an increase in sales in FY2/17 with a 9.9% YoY rise in net sales to ¥113,525mn and a 13.5% decline in ordinary income to ¥6,348mn, missing guidance. Sales improved thanks to the addition of KR Food Service Corporation, which was purchased in FY2/16, to consolidated results, full-year sales contributions from outlets opened in FY2/16, and sales from newly opened outlets in FY2/17 (116 outlets). Yet sales still undershot guidance because same-outlet sales only reached 95.3% of the year-ago level (vs. 97.8% in guidance), mainly due to slower consumption activity and inclement weather that affected suburban and countryside restaurant operations. Additionally, the Company faced a downturn in average customer spend due to changes in dinner availability hours at ISOMARU SUISAN and temporary customer defections owing to inadequate notification of changes to the member points program at Kagonoya (Specialty Brand Category).

The Company is currently reviewing issues and preparing detailed measures for accelerating growth from FY2/19. In the CR Category, it plans to revamp the format from the “general buffet” style up to now to specialized buffets (steak & buffet). In the SFP Category, it intends to strategically curtail new openings and position outlets mainly in prime city-center locations. It will also strengthen existing outlets with renovations, touch-panel deployment, and enhanced banquet menus. The Company is putting efforts into development of a new format, besides existing ISOMARU SUISAN and Toriyoshi Shoten, and Toragoro, a “gyoza” izakaya format, is having a healthy start. In the Specialty Brand Category, it launched a new outlet format with excellent investment efficiency.

The FY2/18 guidance calls for higher sales and earnings with a 3.9% YoY rise in net sales to ¥118,000mn and a 7.1% increase in ordinary income to ¥6,800mn. The modest growth outlook reflects emphasis on reinforcing the business foundation, including curtailment of new outlet opening number, reinforcement of existing outlets, and development of new formats, as the prelude to a renewed growth trajectory.

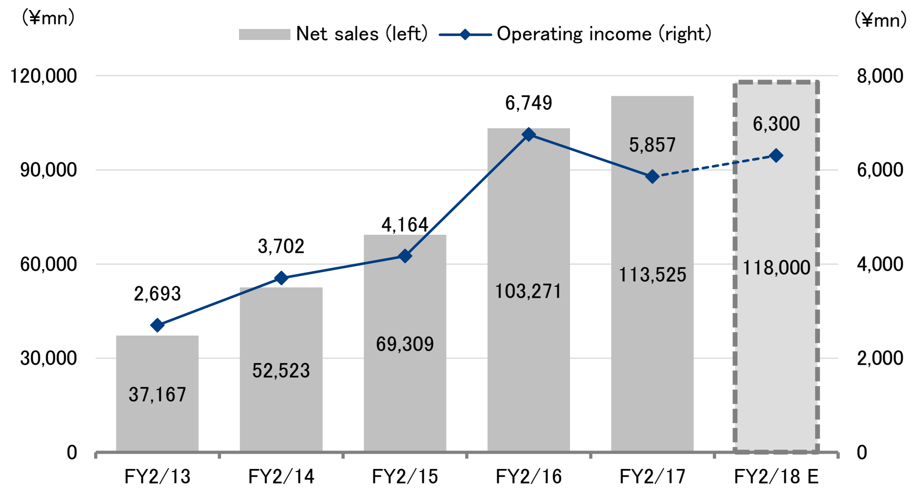
The Company announced a new three-year medium-term business plan in light of FY2/17 results missing initial targets and the prospect of just modest growth in FY2/18 results. However, the plan retains the fundamental growth scenario and targets earnings growth from FY2/19. In its "Group Federation Management" that absorbs restaurant brands with robust growth potential acquired through aggressive M&A to drive growth, the Company intends to accelerate growth with 1) organic outlet openings, 2) domestic M&A, and 3) further overseas initiatives. Plan goals for final-year FY2/20 (not including M&A) are ¥150,000mn in net sales (9.8% average growth over three years) and ¥10,000mn in ordinary income (16.6%).

We think the Company should be capable of attaining medium-term plan goals because it still has considerable room to open izakaya restaurants that drive growth, the M&A environment is healthy, and overseas business should benefit from accumulated know-how and popularity of Japanese foods. Key to watch points are outcomes from existing-outlet reinforcement, income contributions from new formats, the pace of overseas initiatives, M&A deal activity, and creation of group synergies.

Key Points

- Profit lower on higher sales in FY2/17 mainly due to weaker consumption activity, missed guidance
- Focus on solidifying the foundation to accelerate growth from FY2/19 by reinforcing existing outlets and developing new formats
- Expects a temporary flat stage in FY2/18 results, aiming for renewed growth from FY2/19

Results trends



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

Company profile

Implements “Group Federation Management” that pursues a variety of formats utilizing aggressive M&A

1. Business content

The Company mainly operates restaurants and food courts at shopping centers and has moved into izakaya-type restaurants and other restaurants acquired through M&A deals. As a holding company, it brings together 14 consolidated subsidiaries (including 5 overseas firms)* and 2 unconsolidated subsidiaries companies (as of end of FY2/17).

* Consolidated a Taiwanese subsidiary from FY2/17

The Company carefully selects locations that attract large numbers of customers, and employs a distinctive multi-brand, multi-location strategy, which involves developing a variety of restaurant formats attuned to specific locations (regional characteristics, customer attributes, and competition status, etc.). This strategy has supported the Company’s main business. Further, recently, the Company is achieving a high growth rate by promoting “Group Federation Management,” which involves incorporating various brands with high growth potential into the Company’s own growth profile through aggressive M&A activities. Currently, as of end-February 2017, the Company has 857 restaurants in approximately 200 brands.

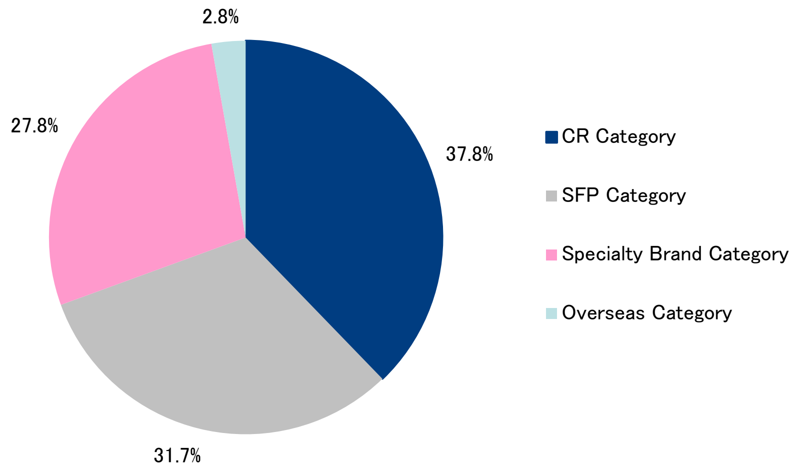
The Company’s businesses are divided into four categories: (1) the CR Category, involving the operation of restaurants and food courts with multiple brands mainly at commercial facilities, (2) the SFP Category, involving the operation of izakaya formats, (3) the Specialty Brands Category, involving the operation of various restaurant formats, and (4) the Overseas Category, which involves operation of Japanese restaurants in Singapore, Hong Kong, and so forth. The mainstay CR Category makes up 37.8% of the Company’s sales, while the SFP Category makes up 31.7%, the Specialty Brands Category 27.8%, and the Overseas Category 2.8% (as of the end of FY2/17).

Overview of business categories (as of end-February 2017)

CR Category	Comprising outlets operated by create restaurants (CR) and create dining (CD). Operates restaurants and food courts with multiple brands mainly at commercial facilities. 421 outlets as of end-February 2017. Main brands include Harvest, Shabu Sai, Rio Grande Grill, and Roast Beef Hoshi.
SFP Category	Comprising outlets operated by SFP Dining, which the Company entered into a capital tie-up, in April 2013. Operating izakaya in urban downtown districts. 212 outlets as of end-February 2017. Main brands include seafood izakaya ISOMARU SUISAN and fried chicken wing specialty outlets Toriyoshi and Toriyoshi Shoten.
Specialty Brand Categories	Comprised of KR Food Service (KR), LE MONDE DES GOURMET (LG), eatwalk (EW), YUNARI (YNR), and Gourmet Brands Company (GBC). The Company is developing their respective specialty brands, focusing on Kagonoya mainly for roadside locations and urban commercial facilities. 189 outlets as of end-February 2017. Main brands in this category include Kagonoya Japanese restaurants, TANTO TANTO Italian restaurants, primarily vegetable-based AWkitchen Italian restaurants, Tsukemen TETSU, and JEAN FRANCOIS bakery and café.
Overseas Category	Comprised of outlets operated by the Company’s Singaporean, Hong Kong, and Taiwanese subsidiaries. 35 outlets as of end-February 2017. Shabu Sai, MACCHA HOUSE and others form the main brands.

Source: Prepared by FISCO from the Company materials and interviews

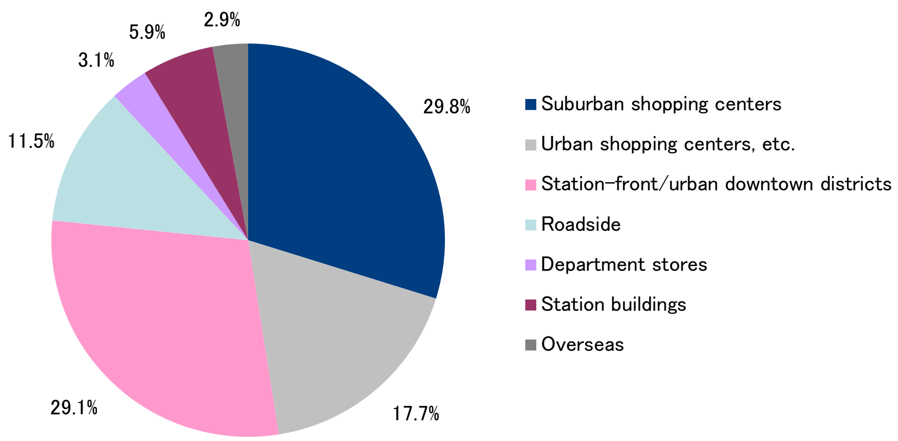
Net sales by category (FY2/17 actual results)



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

Further, the breakdown of outlet numbers by location shows 29.8% for suburban SC, 17.7% for urban SC, 29.1% for station-front and urban downtown districts, 11.5% for roadside, 5.9% in station buildings, 3.1% for department store, and 2.9% overseas; having achieved a good, balanced distribution from the previous concentration in commercial facilities (as of the end of FY2/17).

Composition of outlet numbers by location (as of end-February 2017)



Source: Prepared by FISCO from interviews

Established a subsidiary in New York for the purpose of developing the US business in February 2016

2. History

The Company was established in 1997 as the Yokosuka Brewing Company K.K. (the trading name was changed to create restaurants inc. in 1999) by Tokuju, K.K., the family business of the Company's current chairman, Hitoshi Gotoh. However, its actual foundation was in 1999, when it took over the operation of five western-style restaurants from Tokuju and started the restaurant business in earnest. In 2000, then employee of Mitsubishi Corporation <8058> and current representative director, president and CEO Haruhiko Okamoto engaged with the Company through an in-house venture scheme, with the Company also receiving a capital investment from Mitsubishi (the capital relationship with Mitsubishi was terminated in 2012). Thereafter, backed by Mitsubishi's credit capabilities and other resources, the Company accelerated its growth by increasing its number of restaurants, mainly opening them in commercial facilities and similar locations. In 2005, the Company listed on the Tokyo Stock Exchange Mothers market, changing to the First Section of the Tokyo Stock Exchange in 2013.

The Company has also been aggressive in M&A, bringing the Japanese cuisine chain KISSHO under its umbrella in 2007 and shifting to a holding company structure in 2010 to establish a platform for "Group Federation Management." Subsequently, the Company has acquired LE MONDE DES GOURMET in 2012, SFP Dining and eatwalk in 2013, YUNARI and Shanghai Bishoku Chushin Co., Ltd. (trading name changed from R21 Cuisine) in 2014, KR Food Service and RC Japan in 2015, successively bring them into the Group. SFP Dining was listed on the Second Section of the Tokyo Stock Exchange in December 2014 (a subsidiary listing).

In overseas development, the Company started in 2008 by establishing a joint venture with a local company in Shanghai, and among other initiatives went on to establish wholly-owned subsidiaries in mainland China in 2010, Singapore in 2011, Hong Kong in 2012, and Taiwan in 2014. While the Company's overseas development is still considered to be in the experimental stage, it is preparing the groundwork for a full-fledged expansion in the future. In February 2016 it established a subsidiary in New York also aimed at a US rollout. The Company completed the exit of all outlets from China (Shanghai) at the end of August.

Corporate characteristics

Possesses a strong brand portfolio with industry development capabilities and robust M&A results

1. Multi-brand, multi-location strategy

The characteristics of the Company's main business are 1) opening restaurants in commercial facilities that attract large numbers of customers (shopping centers, station buildings, etc.) and 2) operating diverse brands attuned to their local environments (regional characteristics and customer attributes, status of competition, etc.). The diversity of these formats, including Japanese, Western, and Chinese cuisine, as well as ethnic food and cafes, enables the Company to open multiple restaurants within a single commercial facility and respond to various needs of the facility owner (developer, etc.). This has worked to the Company's advantage in opening restaurants inside commercial facilities, which typically have a higher barrier to entry. Naturally, there is also a cost factor involved in creating multiple formats attuned to their local environments; however, the capacity to open formats that use the customer drawing power of favorable locations to maximum advantage is the Company's true worth. It has accumulated brands development and operational know-how that are the source of its value creation.

On the other hand, the seafood izakaya ISOMARU SUISAN, developed by SFP Dining which was acquired in 2013, has as a special characteristic in its 24-hour operation in station-front locations populated with convenience stores and drug stores. In challenging fierce competition with street-level outlets the chain deliberately selected high-cost station-front sites due to its insistence on locations that attract large numbers of customers. This may be cited as one reason why the chain has a strong affinity with the strategy employed by the Company thus far. Therefore, it can be seen as an extension of the scope of the multi-location strategy to include the street-level outlet domain, and it could pave the way for future full-scale development of diverse formats among street-level outlets in urban downtown districts, in addition to the existing commercial facilities. Further, the Kagonoya Japanese restaurant chain by KR Food Service has been developed focused on roadside locations, and via aggressive M&A including other specialty brands, the Company will strive to further expand location diversity and brand specialization.

2. Growth model based on "Group Federation Management"

In addition to organic (internal) growth, the Company's growth model is one which through supporting additional growth by, as well as engaging with high growth potential formats via M&A, creating various synergies and providing a platform (support from a funding and management perspective etc.), leads ultimately into its own growth. In the past the Company expanded its operational base through operating restaurants in commercial facilities and food courts. However, given that it was a growth model that was readily influenced by the commercial facility's circumstances, as well as shifting to a holding company structure, the Company sought to transition to a strategy that aims for autonomous growth via "Group Federation Management." Understandably, it is felt that success also came from the fact that for the Company, which was established from an internal Mitsubishi Corporation venture, it was a management style that was familiar from a management resource (with staff etc. that were skilled in business management) and cultural perspective, and further, the recognition that it was a partner with which a relationship could be readily formed with relatively little resistance also from capital tie-up partners.

Financial results

Sustaining high growth potential and profitability through aggressive outlet additions including M&A

1. "Group Federation Management" progress and results trends

Looking back at results, expansion in outlet numbers, via new outlet openings and M&A, has been the driver of results growth. In particular, the turning point was from FY2/13 with a shift to a new growth strategy through "Group Federation Management." As well as bringing a range of formats with growth potential into the group, while realizing high growth potential by supporting further outlet expansion, the Company sought to enhance location diversity and specialty branding. Looking at the composition of outlet numbers by location, at end-February 2012, commercial facilities (the total of suburban SC and urban SC) represented 78.4% of overall numbers. However, at end- February 2017 while representation by commercial facilities had shrunk to 47.5%, a balanced portfolio had been established with station-front outlets and those in urban downtown districts (29.1%) and roadside outlets (11.5%) having been newly added.

Outlet openings and closings (including M&A) and period end outlet number trends

	New restaurant openings	Outlet closures	Acquired via M&A	Period end outlet numbers
FY2/12	14	-33	0	356
FY2/13	45	-29	7	381
FY2/14	61	-36	108	514
FY2/15	102	-42	26	616
FY2/16	108	-38	109	795
FY2/17	116	-54	0	857

* From FY2/15 period end outlet numbers record total outlet numbers including outlets where outsourced operations are provided, FC outlets, non-consolidated outlets and overseas J/V outlets.
Source: Prepared by FISCO from the Company's results briefing materials

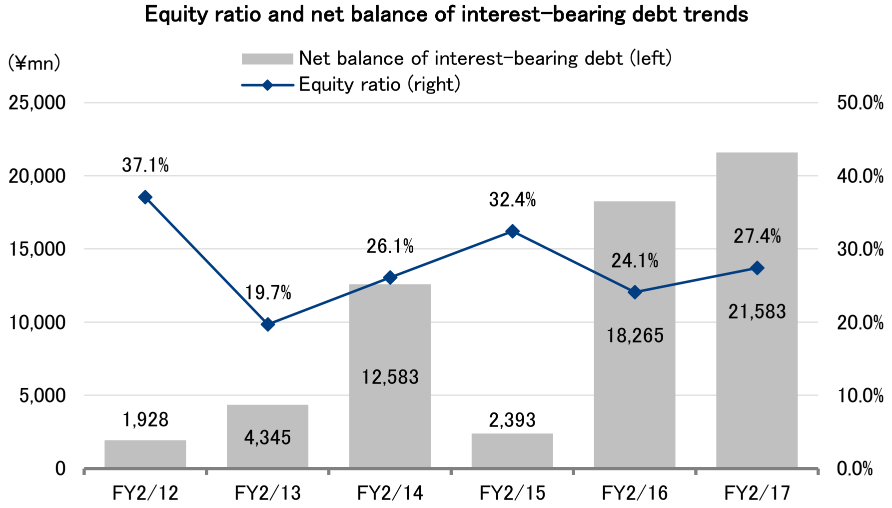
Historical M&A track record

Date acquired	Company name	Main brand(s)	Acquisition price (¥mn)
March 2012	LE MONDE DES GOURMET	"TANTO TANTO"	Undisclosed
April 2013	SFP Dining	"ISOMARU SUISAN," "Toriyoshi Shoten," etc.	6,573
April 2013	eatwalk	"AWkitchen," "Yasaiyamei," etc.	858
April 2014	YUNARI	"Tsukemen TETSU," etc.	1,506
November 2014	Shanghai Bishoku Chushin	"Nanxiang Mantou Dian"	180
June 2015	KR Food Service	"Kagonoya," etc.	14,979
August 2015	RC Japan	"Rain Forest Café," etc.	65

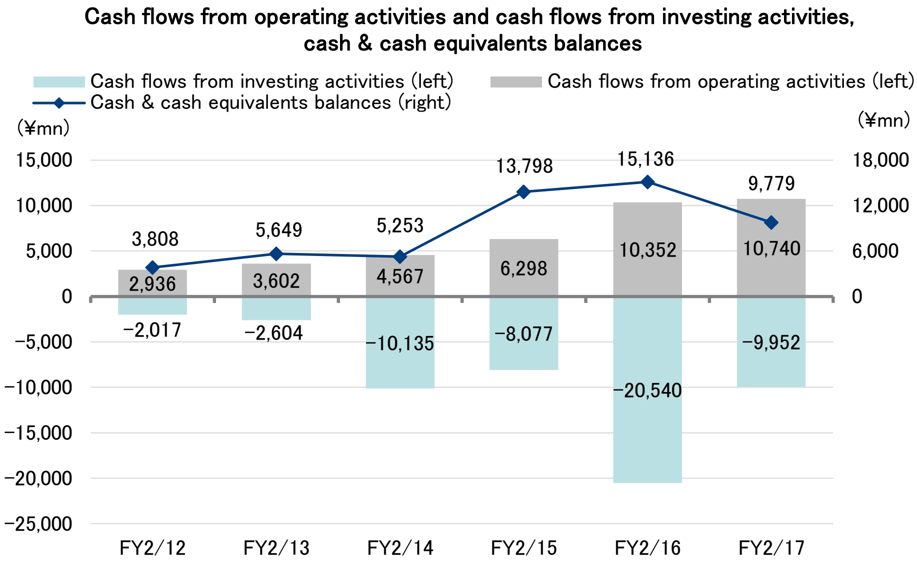
Source: Prepared by FISCO from the Company press releases

From a financial perspective, despite the equity ratio, which represents the stability of the financial foundation, achieving a level that exceeded 35% by FY2/12, the shares held by Mitsubishi Corporation were acquired by way of TOB, and as a result of around 80% of those shares being retired it declined to 19.7% at end-FY2/13. In FY2/14, equity was strengthened through the sale of treasury shares and the equity ratio improved to 32.4% temporarily due to a new share issuance in line with the listing (subsidiary listing) of SFP Dining in FY2/15. However, it declined again to 24.1% at the end of FY2/16 due to the acquisition of KR Food Service. Net interest bearing debt rose significantly to ¥18,875mn.

The cash flow status up to FY2/13 shows cash flow from investment activities trended within stable cash flow from operating activities, however, from FY2/14, due to aggressive new outlet opening and M&A, cash flow from investment activities has expanded significantly.



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



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

For the Company, which aims to continue to aggressively engage in M&A, strengthening the financial foundation is an issue. However, having secured a net D/E ratio of 0.97*1 and net interest bearing debt to cash flow ratio of 1.76*2, it is thought that for the time being there are no concerns regarding financing capabilities judging from its past track record and ample operating cash flows.

*1 Net D/E ratio is calculated as net interest-bearing debt / equity. Generally, a multiple of less than 1x is rated as having no safety concerns.
*2 Net interest-bearing debt to cash flow ratio is calculated as net interest bearing debt / cash flows from operating activities. It is an indicator determining how many years of cash flows from operating activities are required to repay interest bearing debt, with it generally regarded as of concern if repayment capability exceeds 10x.

Lower profits on higher sales in FY2/17 mainly due to weaker consumption, missed guidance

2. FY2/17 results overview

The FY2/17 results showed net sales of ¥113,525mn (up 9.9% YoY), operating income of ¥5,857mn (down 13.2% YoY), ordinary income of ¥6,348mn (down 13.5% YoY) and profit attributable to owners of parent of ¥3,293mn (down 0.8% YoY). Profits fell despite higher sales, and both sales and earnings missed guidance.

While normalization of the number of consolidated months from SFP Dining (down from 14 months to 12 months) had a negative impact, sales received boosts from consolidating KR Food Service acquired in FY2/16 (adding about ¥8.2bn), full-year contributions from outlets opened in the previous fiscal year (108 outlets), and sales from outlets opened in FY2/17 (116 outlets). The CR Category added more outlets than planned, mainly from upbeat roast-beef donburi specialty outlets, and the SFP Category benefited from the popular ISOMARU SUISAN format and full-fledged outlet openings for Toriyoshi Shoten*, the second major brand. The Company operated 857 outlets at end-FY2/17, following 116 outlet additions and 54 outlet closures during the year.

* This is a new format that applies ISOMARU SUISAN's unique income model (24-hour operation at station-front outlets and outlets in urban downtown districts) to Toriyoshi, the founding business for SFP Dining, that ramped up openings from FY2/17. These outlets can be opened adjacent to ISOMARU SUISAN locations, and the Company aims to expand outlets in prime city-center areas.

However, sales came in below guidance because same-outlet sales undershot at 95.3% YoY (vs. the plan's 97.8%), mainly on weaker consumption and inclement weather that affected suburban and coutryside restaurants. Additionally, the Company faced a downturn in average customer spend due to changes in dinner availability hours at ISOMARU SUISAN and temporary customer defections owing to inadequate notification of changes to the member points program at Kagonoya (Specialty Brand Category). The result was even weaker than lowered guidance (disclosed on January 13, 2017) because signs of improved conditions in the year-end and New Year's season faded from mid-January and the SFP Category faced setbacks from opportunity losses during business suspensions to deploy touch panels and delays in some new outlet openings.

Ordinary income, meanwhile, declined and the ordinary margin slipped to 5.6% (from FY2/16's 7.1%), even though the increase in goodwill amortization charges and removal of one-time income (*) have been expected, owing to the inability of sales growth to absorb higher SG&A expenses, such as opening expenses related to increase in new outlet number and a higher personnel expenses ratio (amid part-time worker shortages and persistently high recruiting costs).

* The Company booked ¥143mn in compensation funds related to outlet closing in FY2/16.

In financial standing, total assets dropped 1.6% from the end of the previous fiscal year to ¥71,364mn because of decline in cash and deposits, while the eqyity ratio climbed to 27.3% (from 24.1%) thanks to the 11.5% rise in equity to ¥19,507mn due to build-up of retained earnings. ROE, which reflects capital efficiency, fell to 17.8% on lower margin, etc. (from 20.3%), though remained at a double-digit level.

Overview of FY2/17 results

(¥mn)

	FY2/16 results		FY2/17 results		Change		FY2/17			
							Initial forecast		Updated guidance (from January 13)	
		% of total		% of total		Change rate		% of total		% of total
Net sales	103,271		113,525		10,254	9.9%	118,000		115,000	
CR Category	41,220	39.9%	42,862	37.8%	1,642	4.0%	43,185	36.6%	43,226	37.6%
SFP Category	36,091	34.9%	35,957	31.7%	-134	-0.4%	38,300	32.5%	36,500	31.7%
Specialty Brand Category	23,062	22.3%	31,530	27.8%	8,468	36.7%	33,134	28.1%	32,089	27.9%
Overseas Category	2,832	2.7%	3,167	2.8%	335	11.8%	3,380	2.9%	3,184	2.8%
Cost of sales	29,769	28.8%	32,823	-	3,054	10.3%	34,113	28.9%	-	-
SG&A expenses	66,751	64.6%	74,844	-	7,993	12.0%	76,286	64.6%	-	-
Operating income	6,749	6.5%	5,857	5.2%	-892	-13.2%	7,600	6.4%	6,900	6.0%
Ordinary income	7,340	7.1%	6,348	5.6%	-992	-13.5%	7,900	6.7%	7,400	6.4%
CR Category	3,735	9.1%	3,710	8.7%	-25	-0.7%	4,011	9.3%	3,931	9.1%
SFP Category	4,349	12.1%	3,560	9.9%	-789	-18.1%	4,100	10.7%	3,800	10.4%
Specialty Brand Category	1,473	6.4%	1,316	4.2%	-157	-10.7%	1,955	5.9%	1,813	5.6%
Overseas Category	164	5.8%	280	8.8%	116	-	246	7.3%	265	8.3%
Profit attributable to owners of parent	3,321	3.2%	3,293	2.9%	-28	-0.8%	4,200	3.6%	3,900	3.4%

Same-outlet sales	100.7%	95.3%
New openings	108	116
M&A	109	0
Closure	38	54
Total number of restaurants	795	857

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

Category results are set out as below.

(1) CR Category

CR Category sales were up 4.0% to ¥42,862mn and category income fell 0.7% to ¥3,710mn. Profit moved slightly lower on higher sales, and both sales and profit missed guidance. Full-year contributions from outlets opened in FY2/16 and 51 outlets opened in FY2/17 (vs. 28 outlets in the plan) boosted sales. New opening number exceeded plans because of stronger inquiries for the upbeat high value-added food court format (roast beef donburi specialty outlet). The sales shortfall versus guidance, however, stemmed from sluggish same-outlet sales at just 96.9% YoY (plan 96.9%), mainly at countryside and suburban shopping centers, under pressure from slower consumption activity. Momentum differs depending on the area with customers shifting toward formats that have lower average pricing in suburban and countryside areas, while high value-added formats perform well in city-center areas. Profit, meanwhile, declined because of increases in opening expenses (setback of about ¥42mn) led by higher new openings number and non-recurrence of one-time income from the previous fiscal year (about ¥142mn). Period-end outlet number was 421 outlets following 51 openings and 24 closures during the year.

(2) SFP Category

The SFP Category posted lower sales and profit with declines of 0.4% to ¥35,957mn in sales and 18.1% to ¥3,560mn in category income. On a real basis, excluding the impact of normalization in the number of consolidated months at SFP Dining (down from 14 months to 12 months), profit fell on increased sales (*). Both sales and profit, meanwhile, were below guidance. Full-year contributions from outlets opened in FY2/16 and 42 outlets opened in FY2/17 (vs. 41 outlets in the plan) supported higher sales. This segment added 34 outlets for the popular ISOMARU SUISAN format and began full-fledged deployment of Toriyoshi Shoten (10 openings including 3 conversions), the second major business. Shortfall versus guidance, however, occurred because of weak same-outlet sales at just 92.4% YoY (vs. 94.2%), due to slower consumption activity and inclement weather. There was also an impact from opportunity losses due to temporary suspensions to deploy touch panels at outlets and initial operational disruptions (unfamiliarity). Shift in dinner-hour usage from primary to secondary and tertiary use appears to be weighing on average customer spend. Profit, on the other hand, dropped because of increases in opening expenses associated with higher new openings number and unexpected costs (such as depreciation expenses for the touch-panel rollout). Period-end outlet number was 212 outlets following 42 openings and 6 closures during the year.

* Consolidated subsidiary SFP Dining reported lower profit on increased sales in FY2/17 with sales up 13.4% YoY to ¥35,957mn and ordinary income down 8.8% to ¥3,560mn.

(3) Specialty Brand Category

The Specialty Brands Category recorded lower profit on improved sales with sales rising 36.7% YoY to ¥31,530mn and category income dropping 10.7% to ¥1,316mn. Both sales and profit missed initial guidance. Consolidated addition from KR Food Service acquired in the previous fiscal year (about ¥8.2bn), full-year contributions from outlets opened in FY2/16, and 19 outlets opened in FY2/17 (vs. 22 outlets in the plan) lifted sales. Shortfall versus guidance, however, occurred because of weak same-outlet sales at just 96.5% YoY (vs. 97.0%). Temporary loss of customer interest caused by inadequate notification of changes in the member point program had an impact. Profit was down due to increases in opening expenses associated with higher new opening number and one-time costs from change in accounting policy (*). Period-end outlet number was 189 outlets following 19 openings and 9 closures during the year.

* Impact of the accounting policy change for the point program allowance at KR Food Service (roughly ¥61mn profit setback).

(4) Overseas Category

The Overseas Category reported higher sales and profit at ¥3,167mn in sales (up 11.8%) and ¥280mn in category profit (up 70.7%). Sales were roughly on track with initial guidance, while profit slightly overshot. Positive factors were consolidation of the Taiwanese subsidiary and upbeat sales and profits in Singapore. Hong Kong business, meanwhile, stayed within the expected range due to weaker economic activity in China. Earnings improved sharply thanks to completion of pulling out all outlets from China (Shanghai) that had been undermining profit. Period-end outlet number was 35 outlets following 4 openings and 15 closures during the year (including 12 outlets as part of the Shanghai exit).

Issues and measures

Aims to strengthen existing outlet business and develop new formats

The Company is reassessing issues for the individual categories and pursuing specific measures to accelerate growth from FY2/19.

(1) CR Category
The Company is revising the "comprehensive-style buffet" format, which has been steadily losing customers mainly at countryside and suburban SCs, to buffet businesses with specialization (such as a meat menu) in light of changing consumer needs. Sales grew 62% YoY at BEEF RUSH (steak & buffet), a new format launched in FY2/16, from the pre-conversion level, a chiered a healthy outcome. The Company intends to open 8 new outlets in FY2/18.

(2) SFP Category
For ISOMARU SUISAN, which encountered a substantial dip at suburban outlets, the Company intends to curtail new openings, particularly in suburban areas readily affected by economic trends, and bolster existing outlets through renovations that improve customer draw and touch panel deployment that boosts average customer spend. It also plans to improve the banquet menu to counter lowering average customer spending at night.

The Company is pursuing development of new formats with lower average customer spend in response to recent advances by specialty izakaya with inexpensive pricing. Toragoro, a gyoza izakaya opened on a trial basis in March 2017 (converted from an ISOMARU SUISAN outlet), utilizes the same unique income model as ISOMARU SUISAN and Toriyoshi Shoten (24-hour operation at station-front outlets and outlets in urban downtown districts). Average customer spend is relatively low at about ¥2,000, but the Company expects sales on par with ISOMARU SUISAN because of high turnover. Sales have been healthy thus far at an increase of 130% YoY, compared to the pre-conversion level.

(3) Specialty Brand Category
KR Food Service, which mainly operates roadside outlets, is working to enhance interaction with point members and develop a format with effective investment efficiency for Kagonoya, a relatively higher-priced restaurant. The new Azusa Coffee (Japanese-style café) format stands out with its comfortable feel and extensive food menu. Investment cost is only about 70% of what is spent on Kagonoya openings (the Company aims to have 15 outlets by the end of February 2020).

Results outlook

Focus on solidifying the foundation to return to a growth trajectory in FY2/18

The Company targets higher sales and profits in FY2/18 at ¥118,000mn in net sales (up 3.9% YoY), ¥6,300mn in operating income (up 7.6%), ¥6,800mn in ordinary income (up 7.1%), and ¥3,300mn in profit attributable to owners of parent (up 0.2%). It presents a moderate growth outlook due to focus on solidifying the base to restore a growth trajectory by curtailing new outlet openings and also improving existing outlets and developing new formats.

The FY2/18 guidance expects boosts from full-year contributions by outlets opened in the previous fiscal year and outlets slated for opening this fiscal year (76 outlets) and higher sales in all categories other than the Overseas Category. However, sales growth is somewhat modest due to curtailment of outlet opening number in the CR Category and SFP Category that had been areas where the Company was aggressively adding outlets. The Company projects same-outlet sales at 97.0% of the year-ago level and 898 outlets at period-end following 76 outlet openings and 35 closures.

In earnings, the Company forecasts a rise in ordinary income, despite higher upfront costs from enhancement of existing outlets and development of new formats, thanks to increased sales and lower outlet-opening expenses related to curtailment of openings. It also factors in a modest rise in ordinary income margin to 5.8% (vs. 5.6% in FY2/17).

Category outlooks are reviewed below.

(1) CR Category

CR Category targets are ¥43,295mn in sales (up 1.0% YoY) and ¥3,757mn in category profit (up 1.3%). The Company expects to open 26 outlets and envisions same-outlet sales at 96.3% of the year-ago level. It will conduct planned outlet openings suited to locations with focus on the roast beef donburi specialty outlet receiving many inquiries from developers. For existing outlets, it intends to convert the buffet format at countryside and suburban shopping centers to the new highly specialized BEEF RUSH format and thereby raise profitability.

(2) SFP Category

The SFP Category targets are ¥37,000mn in sales (up 2.9% YoY) and ¥3,700mn in category profit (up3.9%). The Company expects to open 20 outlets and forecasts same-outlet sales at 97.2% of the year-ago level. It will curtail openings and put effort into reinforcing existing outlets and developing new formats. It aims to develop a third major outlet brand with Toragoro (gyoza izakaya), which had an upbeat launch, as the main candidate in new format development.

(3) Specialty Brand Category

The Specialty Brand Category targets ¥34,686mn in sales (up 10.0% YoY) and ¥1,884mn in category profit (up 43.1%). The Company expects to open 26 outlets and envisions same-outlet sales at 97.7% of the year-ago level. KR Food Service is adding new-format Kamikochi Azusa Coffee outlets, and EW plans to open more of its upbeat Mr. FARMER outlets. Furthermore, KR Food Service hopes to improve income through existing-outlet measures of enhancing contacts with members (240,000 people) and optimizing SA/PA human resources.

(4) Overseas Category

The Overseas Category targets ¥2,976mn in sales (down 6.0% YoY) and ¥34mn in category profit (down 87.9%). The Company plans to open 4 outlets. It will open the first outlet in New York (North America region) in May 2017. The anticipated profit decline factors in closures of high-income outlets in Hong Kong and Singapore (due to contract expiration).

FY2/18 results outlook

(¥mn)

	FY2/17 results		FY2/18 forecast		Change	
		% of total		% of total		Change rate
Net sales	113,525		118,000		4,475	3.9%
CR Category	42,862	37.8%	43,295	36.7%	433	1.0%
SFP Category	35,957	31.7%	37,000	31.4%	1,043	2.9%
Specialty Brand Category	31,530	27.8%	34,686	29.4%	3,156	10.0%
Overseas Category	3,167	2.8%	2,976	2.5%	191	6.0%
Operating income	5,857	5.2%	6,300	5.3%	443	7.6%
Ordinary income	6,348	5.6%	6,800	5.8%	452	7.1%
CR Category	3,710	8.7%	3,757	8.7%	47	1.3%
SFP Category	3,560	9.9%	3,700	10.0%	140	3.9%
Specialty Brand Category	1,316	4.2%	1,884	5.4%	568	43.2%
Overseas Category	280	8.8%	34	1.1%	-246	-
Profit attributable to owners of parent	3,293	2.9%	3,300	2.8%	7	0.2%

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

Growth strategy

Lowered medium-term plan goals, though maintained the core growth scenario

1. Medium-term management plan

The Company is implementing a three-year medium-term business plan (rolling plan). It presented an updated version in light of FY2/17 results missing initial plan targets and the prospect of slower income growth in FY2/18 because of focusing on existing businesses and reinforcement of the growth foundation. The final-year FY2/20 goals (not including M&A deals) are ¥150,000mn in sales (9.7% three-year average growth rate), ¥10,000mn in ordinary income (16.4%), and ¥5,300mn in profit attributable to owners of parent (17.2%). Management delayed the anticipated timing of attaining ¥200bn in sales, including M&A, by 2-3 years from the initial plan (FY2/20). However, while the Company lowered overall income levels to reflect FY2/17 results and FY2/18 projections, it maintained the core growth scenario and outlook for income growth from FY2/19. It aims to accelerate growth within a framework of "Group Federation Management" that utilizes aggressive M&A to capitalize on business areas with growth potential through 1) organic openings, 2) M&A, and 3) further overseas initiatives.

Medium-term management plan (not including M&A)

(¥mn)

	FY2/17		FY2/18 guidance		FY2/19 plan		FY2/20 plan		Average growth rates
	Period-start guidance	Results	Previous	Revised	Previous	Revised	Previous	Revised	
Sales	118,000	113,525	132,000	118,000	145,000	130,000	160,000	150,000	9.7%
(Growth rate)	14.3%	9.9%	11.9%	3.9%	9.8%	10.2%	10.3%	15.4%	
Ordinary income	7,900	6,348	9,400	6,800	10,600	8,000	-	10,000	16.4%
(Ordinary income margin)	6.7%	5.6%	7.1%	5.8%	7.3%	6.2%		6.7%	
Profit attributable to owners of parent	4,200	3,293	5,300	3,300	6,000	4,100	-	5,300	17.2%
(Profit margin)	3.6%	2.9%	4.0%	2.8%	4.1%	3.2%		3.5%	

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

Key points from growth strategies are reviewed below.

(1) Organic openings

The Company intends to open about 90-100 outlets a year by reinforcing its existing formats and expanding new formats. In the CR Category, it will make additions to existing formats and bolster openings of robust new formats, such as BEEF RUSH (steak & buffet), MACCHA HOUSE (Japanese-style café)*, and The COUNTER (order-made hamburgers). In the SFP Category, while the Company will curtail openings in suburban areas easily affected by economic trends, it plans to continue bolstering the two core formats that still have substantial room for more sites (ISOMARU SUISAN and Toriyoshi Shoten) and to ramp up Toragoro (gyoza izakaya), a new format, as a third major brand. If Toragoro gains traction, the Company can substantially broaden opportunities in prime city-center areas, where it performs well, because this format can be opened next to ISOMARU SUISAN and Toriyoshi Shoten outlets. In the Specialty Brand Category, it aims to mainly expand with Azusa Coffee (Japanese-style coffee shop), which offers excellent investment efficiency, and Mr. FARMER (vegetable café), which has been doing well amid a healthy food boom.

* This is a matcha specialty shop with nine outlets mainly in Singapore, Hong Kong, and the Asia region. The Company is promoting "JAPAN SECOND WAVE" concept of reverse importing of matcha culture arranged in the overseas market to Japan. The first domestic outlet opened in May 2015 (Kyoto's Shijokawaramachi) is a popular site with persistent customer lines that has attracted television coverage.

(2) Domestic M&A

The Company aims to continue realizing quality M&A of Japanese and foreign companies that capitalizes on an abundant M&A track record (six deals in the past five years). It currently considers about 60 opportunities a year and wants to boost the pace to 100 opportunities and aggressively pursue deals.

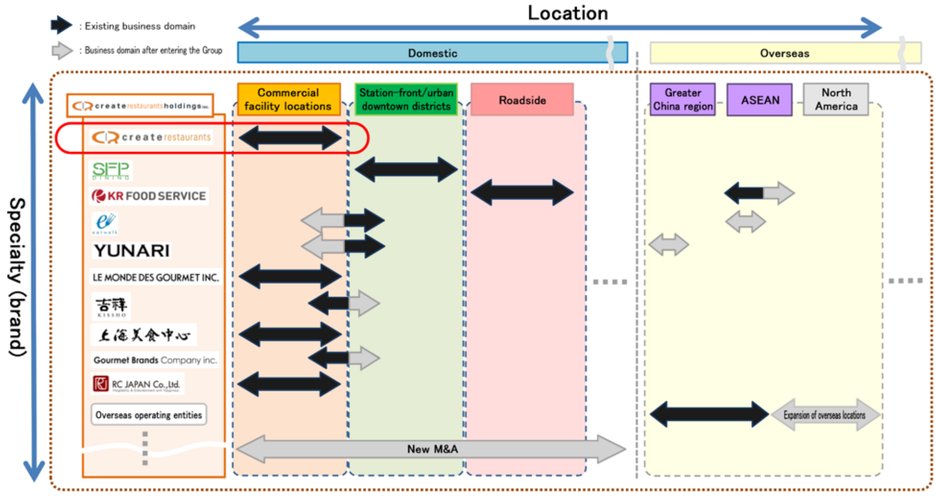
(3) Further overseas expansion

The Company has successfully ramped up overseas business, including two straight years of profitability, thanks to enhancing local management capabilities via localization and other efforts. It plans to accelerate outlet openings in North America and other parts of ASEAN by leveraging know-how from Singapore and Hong Kong business. It is also considering utilization of joint-venture and franchise formats with low investment risk and rapid rollout speed. For North America, it established a local entity in February 2016 and plans to open a New York outlet in May 2017 as a first site. It intends to actively develop business with emphasis on Japanese cuisine. The Company is currently working on a project to open a "HORII NY (provisional name)" restaurant through an alliance with Sarashina Horii, which operates the longstanding "Sarashina Horii" soba shop business.

2. Longer-term growth image

The Company is aiming for continuous growth by building a strong portfolio through further development of “Group Federation Management.” Given that in M&A to date, it has sought to attain location diversity. including commercial facility locations, bustling area and station front locations (SFP) and roadside locations (KR), and overseas locations (Greater China region, ASEAN, and North America etc.), and expanded the variety of formats (specialty brands), the result has produced new growth opportunities by seeking further combinations of location diversity and brand specialization. Its near-term goal is prompt realization of ¥200bn in sales, including M&A. The Company launched “cross-functional teams” for specific themes and has outlined a strategy of addressing issues that extend across the group in order to further advance “Group Federation Management” from FY2/18. It seeks to sharply lower costs for purchasing, outlet design, and hiring and has finally begun moving toward synergy creation.

“Group Federation Management” growth picture



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

We think the Company is capable of attaining medium-term management plan goals owing to existence of sufficient leeway to open izakaya outlets that are growth drivers, a healthy M&A environment, and potential in overseas businesses from accumulated know-how and popularity of Japanese cuisine. While income growth is likely to temporarily moderate in FY2/18, we believe it is a rational decision to promptly respond to environment changes and bolster existing outlets and develop new formats given the prospect of faster growth in the future. Furthermore, the Company’s “Group Federation Management” of expanding scale through aggressive M&A appears to have entered the next phase of movement toward realizing specific synergies. Our focus points are existing-outlet reinforcement results, income contributions from new formats, the pace of overseas initiatives, activities for realizing M&A, and creation of group synergies.

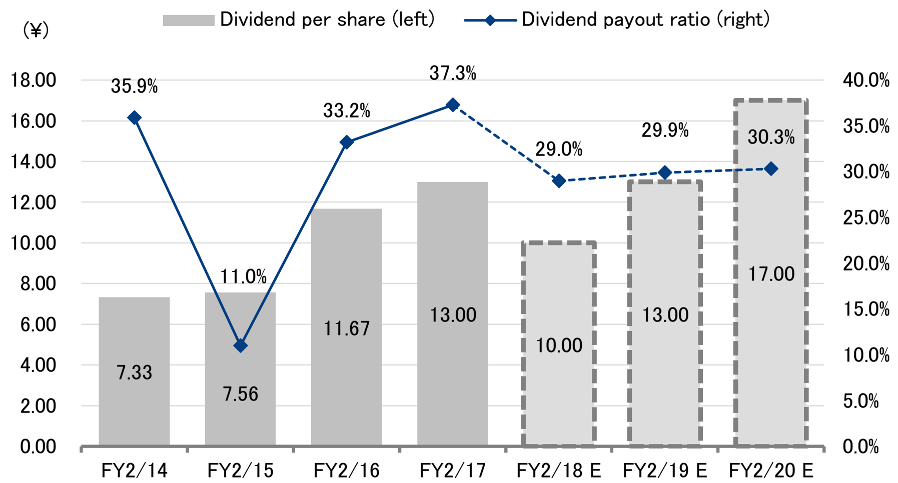
Shareholder returns

Expect temporary dividend decline in FY2/18, though the Company possesses large room for dividend hikes driven by profit growth

The Company has a basic policy of paying a stable dividend with a target of about 30% for the consolidated dividend payout ratio while taking into account earnings and future business initiatives. It intends to pay a ¥13 per share dividend in FY2/17 (¥6.5 interim, ¥6.5 year-end) in line with the initial outlook (for a 37.3% payout ratio). The FY2/18 guidance sets the dividend target at ¥10 per share (¥5 interim, ¥5 year-end) for an anticipated 29.0% ratio. The medium-term business plan puts annual dividend targets at ¥13 per share in FY2/19 (29.9%) and ¥17 per share in FY2/20 (30.3%).

We also expect a temporary dividend decline in FY2/18, but see substantial room for dividend hikes accompanying profit growth from FY2/19.

Dividend per share and dividend payout ratio



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

Aiming to enhance liquidity, the Company undertook a 3-for-1 stock split with February 29, 2016 as the date of record. Further, it announced accordingly an expansion of its shareholders' benefits program, with August 31, 2016 as the date of record. Twice a year, in February and August, it distributes meal vouchers to the value of ¥3,000 (¥6,000 annually) to shareholders with 100-499 shares, ¥6,000 (¥12,000 annually) to shareholders with 500-1,499 shares, ¥15,000 (¥30,000 annually) to shareholders with 1,500-4,499 shares, and ¥30,000 (¥60,000 annually) to shareholders with 4,500 or more shares.

Disclaimer