COMPANY RESEARCH AND ANALYSIS REPORT

Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange First Section

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Index

Summary

Profits rose sharply on lower sales amid ongoing difficult market conditions, aims to solidify an earnings structure unaffected by the market environment

Daikoku Denki Co., Ltd. <6430> (hereafter, "the Company") has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese pinball) parlors or halls, and the other that develops, produces and sells display and control units for pachinko and pachislot machines. The Company holds the leading share of the Japanese market for hall computers, of approximately 35%, reflecting an information management method that is the de facto standard for the industry. The Daikoku Denki Strategic Information System (DK-SIS) supplies information to support the operations of pachinko hall associations. It is the only such system in Japan and was used by 3,709 pachinko and pachislot halls at March 31, 2017. It has also made a fully fledged entry into the manufacture and sales of in-house developed pachislot machines.

Japan's pachinko market has been shrinking for several years. In response, the Company seeks to reform its businesses over the medium to long term. Reforms include developing a next-generation hall computer, shifting to a business model more reliant on services that provide recurring revenues and developing and commercializing pachislot machines. These reforms have produced results to a certain extent. In particular, the next-generation hall computer (including peripheral equipment), on which the Company has invested aggressively, is in its final stage of development. This hall computer will operate on a cloud server and be capable of advanced analysis of large quantities of data. It will be far superior to any competing computer and should allow the Company to increase its share of the Japanese market for these machines. Recently, however, business performance has remained under pressure due to the inception of specific measures to address the industry's policy of collecting and removing "all the pachinko game machines whose performance may differ from the models that were submitted for format inspection" in 2016, in addition to the adoption in 2015 of industry restrictions on risky machines.

The Company posted sharply higher earnings on lower sales in FY3/17 with net sales at ¥40,714mn (-13.4%) and operating profit at ¥1,048mn (vs. a loss of ¥894mn in the previous fiscal year). Sales stalled in Information System Segment and Control System Segment amid continuation of difficult market conditions, including "collecting and removing" impact. In particular, Information System Segment weakened considerably because of decline in new pachinko hall openings and diminished investment appetite for peripheral equipment upgrades. Furthermore, the Control System Segment substantially missed forecast due to revision of sales schedules at amusement equipment firms. Earnings rose sharply, meanwhile, thanks to upbeat sales of new products and a lull in R&D spending.

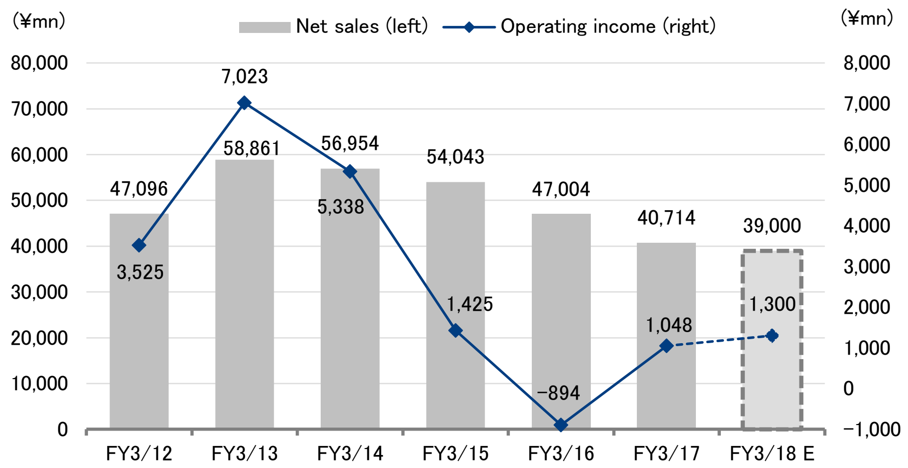
In FY3/18, the Company forecasts for a similar pattern of vibrant earnings growth on weaker sales with net sales at ¥39,000mn (-4.2%) and operating profit at ¥1,300mn (+24.0%). It expects higher sales in Information System Segment thanks to the new product launches, but downward pressure from shrinkage of the Control System Segment. For earnings, meanwhile, it projects a gain in operating profit primarily because of decline in R&D expenses and improved income in the Control System Segment.

The Company is currently promoting the "Next 50 Chapter One" medium-term business plan that lasts through FY3/20. In FY3/18, the second year of the plan, it moved to a new team, including replacement of the president, to help in addressing sharp changes in the business environment, and altered the organization to strengthen its income structure. Nevertheless, the Company did not change numerical goals or the overall direction. It intends to enhance growth potential and profitability through expansion of market share with next-generation products and new value creation by leveraging data analysis and planning and development capabilities. We expect the Company to gauge the timing of the rollout of the next-generation hall computer in light of response to "measures for dealing with addictions," a new issue in the industry, and market environment trends. Peripheral equipment, which should be steadily released ahead of the rollout, is likely to fuel income during this period by tapping into replacement demand at existing customers. We hence think the Company deserves notice for its solidification of an income structure that is unaffected by the market environment, including expansion of MG services that have become a stable income source. While uncertainty should continue in the near term, we see opportunities for growth in the Company's business over the longer term by leveraging its dominant position and will also be focusing on initiatives to stimulate the overall industry.

Key Points

- Earnings rose sharply on lower sales in FY3/17 amid a difficult market environment
- Profitability improved on upbeat sales of new products to existing customers and a lull in R&D expenses
- Pushing ahead with the new medium-term plan, called "Next 50 Chapter One," with FY3/20 the final year of the plan
- Seeking to boost market share with next-generation products and solidify an earnings structure unaffected by the market environment

Trends in full-year results



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

Description of businesses

Holds No.1 industry shares in hall computers and peripheral equipment for the pachinko industry with support from provision of the industry's main information control method

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

As the pioneer in the development of hall computers, which assist the management of pachinko halls, the Company won hall's trust and pachinko fans' satisfaction by providing a management system which puts emphasis on data management, introduction of innovative peripheral equipment for its hall computers, and utilization of the leading membership information service in the pachinko industry; and it holds the top share of the Japanese market for hall computers.

In FY3/17, the Company held an approximately 35% share of the Japanese market for hall computers, indicating that it served about 3,900 halls.

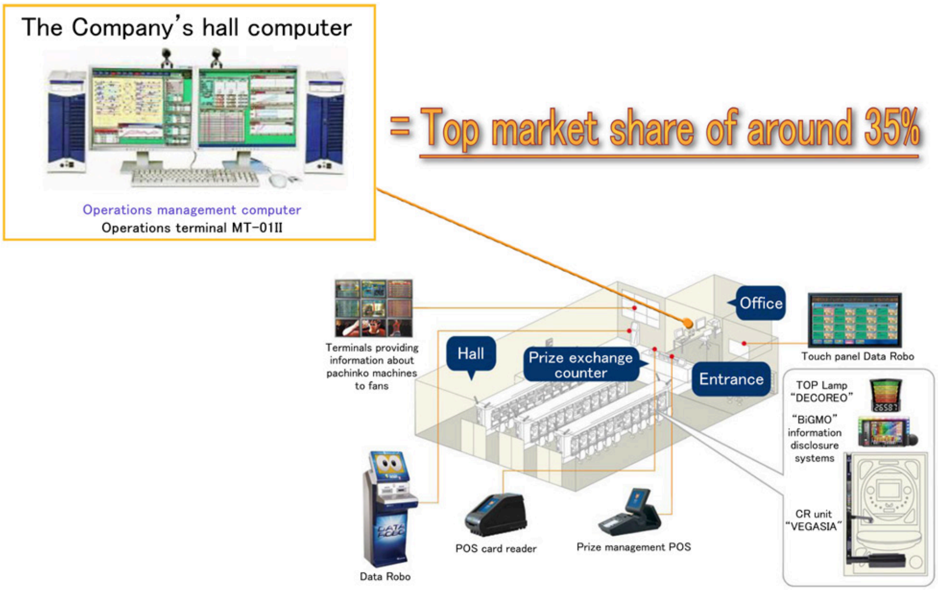
The Company's two main businesses are the Information System Segment and the Control System Segment, but the Information System Segment provided approximately 67.0% of its total sales in FY3/17 and was the main source of stable profit.

1. Information System Segment

The Information System Segment offers a complete line of information equipment and services to support sales and operational management at pachinko halls. Hall computers are the core of the system used at halls, and these computers are supported by peripheral equipment, such as prize management systems and information display systems. The segment also offers various services such as hall management support services, through the information equipment, and unique DK-SIS system, which is the leading service in Japan that provides strategic information about associated halls.

Hall computers are the core systems for supporting pachinko hall operations. These personal computers display the operating condition and sales of each machine in a hall. As mentioned above, these computers are supported by peripheral equipment, such as prize management systems and information display systems. They also serve as the foundation of the DK-SIS system. Peripheral equipment and support services are often sold with hall computers as a package deal. The Company has been strengthening the sale of services for its information system equipment because it earns regular fee income from these services.

Hall computers and main peripheral equipment



Source: The Company's results briefing materials

2. Control System Segment

The Control System Segment produces LCD display units, control units, switches and motors for pachinko and pachislot machines. Applying the knowledge obtained during many years of analyzing data from pachinko machines through its DK-SIS, the Segment analyzes trends in the popularity of pachinko machines and presents ideas to makers of these machines for the manufacture of hit machines. It also serves as a partner to machine manufacturers in developing appealing content for their machines and helps the manufacturers obtain the rights to use animation characters in their machines.

Since FY3/14, the Company's consolidated subsidiary Daxel Inc. has been producing and selling pachislot machines developed by Daikoku Denki under the Daxel brand name. The first such machine, called "Magical Suite Prism Nana", sold 4,000 units. The second machine, "Sasamisan@Gambaranai Slot", sold 6,000 units. The third, "Pachislot Hyakkaryoran Samurai Girls", sold 5,100 units. The success of these machines demonstrates the Company's ability to develop products with great appeal as games. The Company has established a high-quality brand image specializing in animation characters. The Company released "Detective Opera Milky Holmes TD Kieta 7 and Kiseki-no-Uta" (sold 8,800 machines) and "Pachislot Witch Craft Works" (3,500 machines) in FY3/17. It is also releasing "Sora-no-Otoshimono Forte" and "Yuki Yuna is a Hero" models in FY3/18.

New product

Source: The Company's results briefing materials

Company strengths

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

1. Growth model based on market expansion through innovation

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

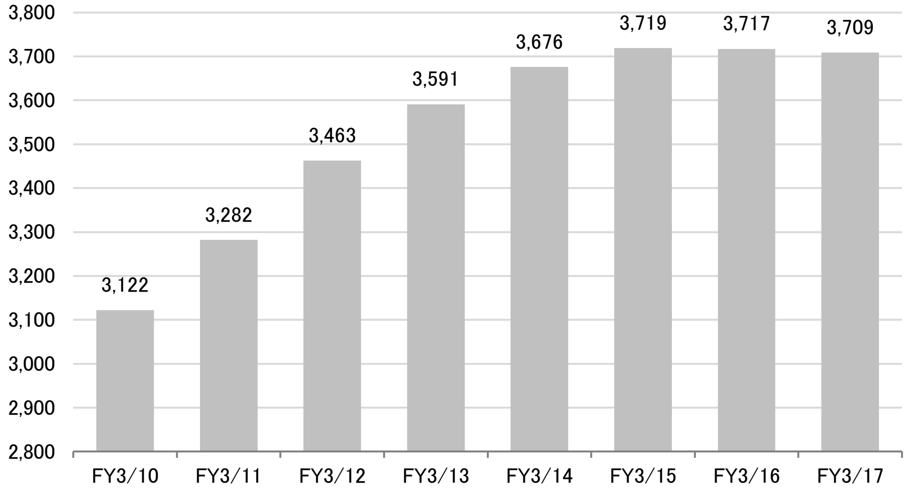
Launched in 1974, the Company's first hall computer enabled the managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic information, but with the introduction of hall computers, data-based hall management became the de facto standard. In subsequent years, the Company developed other kinds of information equipment with revolutionary functions. One such piece of equipment was the Data Robo terminal, which provides information about different models of pachinko and pachislot machines to the users of these machines. This equipment has increased the satisfaction of pachinko machine users and the efficiency of pachinko hall management, as well as the profitability of pachinko halls.

A newer business being pursued by the Company is the development, production, and sale of pachislot machines that differ from previous pachinko and pachislot machines, which tended to be chosen based on the gambling appeal. The Company's pachislot machines display original characters produced by popular illustrators in anime using original voices. These high-quality machines have won accolades from fans of anime, and the Company has again established a new market for amusement equipment.

2. A strong network of pachinko halls

Another advantage the Company has is the hall computer based membership information service. This service connects the Company and member pachinko halls through networks, and gathers, processes and analyzes the daily operational information of pachinko halls recorded by hall computers and gives feed-back to the managers of these halls to improve their operations. The managers of halls in which Daikoku Denki's hall computers are installed receive operational data daily on all the pachinko machines in Japan equipped with the Company's hall computers. They also receive operational data broken down by the model of pachinko machine. This information enables them to improve the running of their businesses. At the same time, the Company maintains firm ties with the halls using its equipment, which supports the Company's business. The Company's DK-SIS allows it to serve as a think tank on the pachinko industry and elevates the Company's brand name. At the end of March 2017, the number of pachinko and pachislot halls in the Company's network was 3,709, which operated approximately 1.45mn machines, or 32.0% of all the machines installed in Japan, and gathered data on ¥9.5tn worth of annual sales.

Number of pachinko halls in Daikoku Denki's network

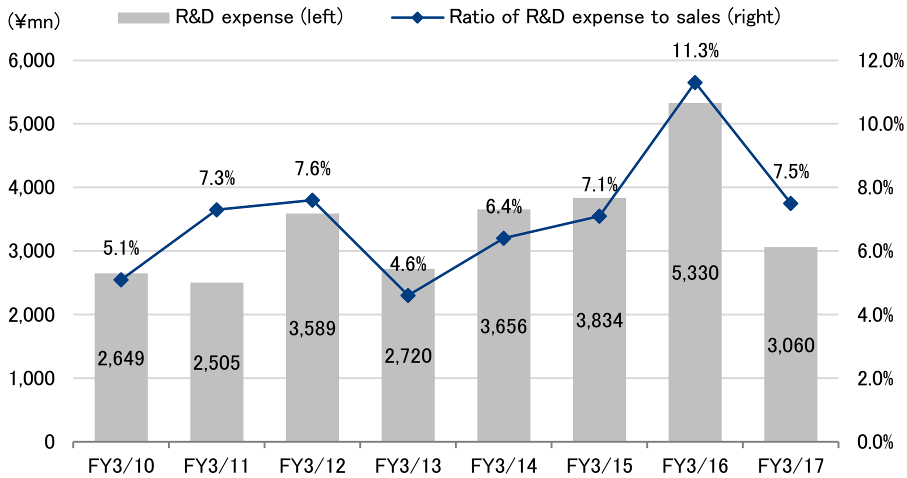


Source: Prepared by FISCO from the Company's results briefing materials

3. Stable profit base that supports investment for the future

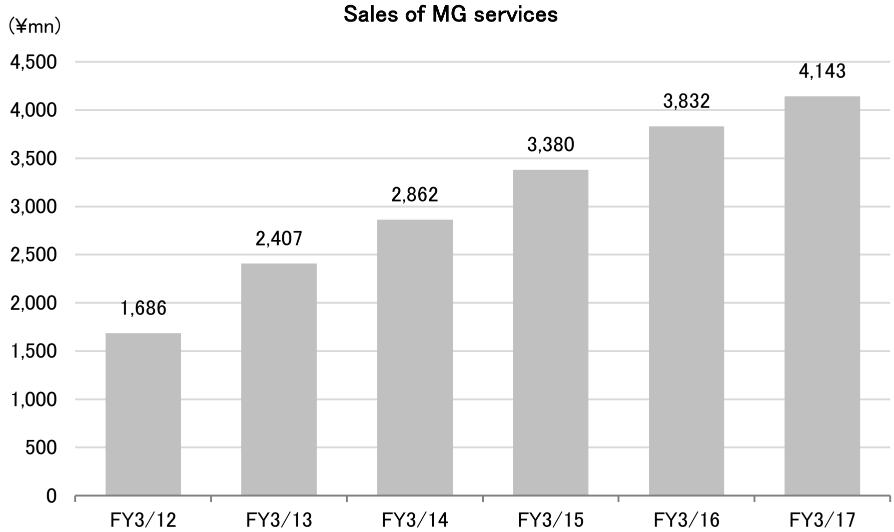
The Company's main source of competitiveness is its proactive upfront investment in goods and services, including its R&D expenditure. Over the past few years, the Company has developed unique pachislot machines, a next-generation hall computer (including peripheral equipment), and other products to drive its sales and profit growth hereafter. The stable revenue stream or Cash Cow provided by the high-margin Information System Segment makes this investment possible. In particular, the management support services (MG services) nurtured by the Company provide enough profit to maintain funding the investment in R&D at a high level, greatly limiting investment risk. The Company's ability to balance large profits from its existing businesses with heavy investment in businesses of the future allows it to produce value on a continuing basis.

Research and development expense and ratio of expense to sales



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

Sales of MG services



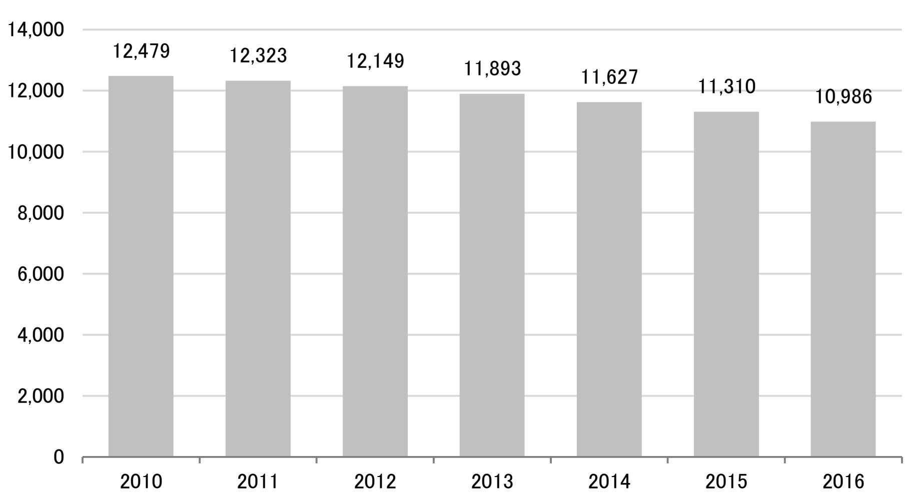
Source: Prepared by FISCO from the Company's results briefing materials

Industry environment

Uncertainty likely to continue in the near term, though expecting Japan to overcome the deflationary economy and moderate recovery in the medium term

Japan's pachinko industry has been shrinking for years, reflecting a decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The 2015 adoption of industry restrictions on risky machines and addressing the industry's policy in force self-regulating game machines are specific issues that have the entire industry in a slumping mood. According to surveys by the National Police Agency, the number of pachinko and pachislot halls in Japan declined at an average annual rate of 2.3% from 2011 to 2016. In 2016, the number of halls was 10,986 (down 324 halls YoY). It is estimated that the Company served about 3,900 of these halls based on the fact that it held approximately 35% of the Japanese market for hall computers in FY3/17 according to Company estimates. Most of the Company's customers are high-end, large pachinko halls that are the top performers in their respective local markets, averaging 519.1 machines per hall, or about 30% more than the average number of machines per hall, according to the National Police Agency. Therefore, the business of these customer halls is relatively insensitive to economic cycles, and the halls can invest in new businesses.

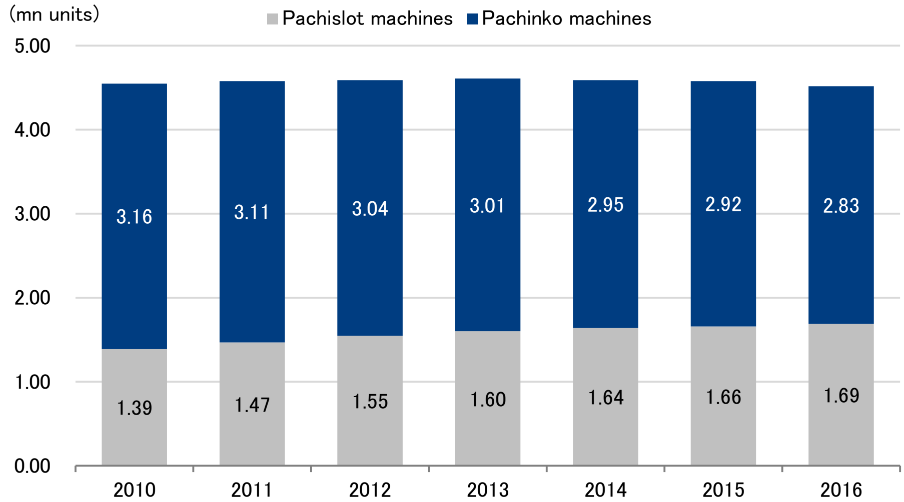
Number of pachinko and pachislot halls in Japan



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

However, the National Police Agency reports that, while the number of pachislot machines has increased, the number of pachinko machines in Japan has declined, so the combined number of pachinko and pachislot machines has remained fairly constant. Since the number of pachinko and pachislot halls decreased over the same period, the average size of halls has increased. This trend toward larger pachinko and pachislot halls that command merits of scale benefits the Company, which invests effectively in developing equipment with advanced functions and services with added value.

Number of pachinko and pachislot machines in Japan

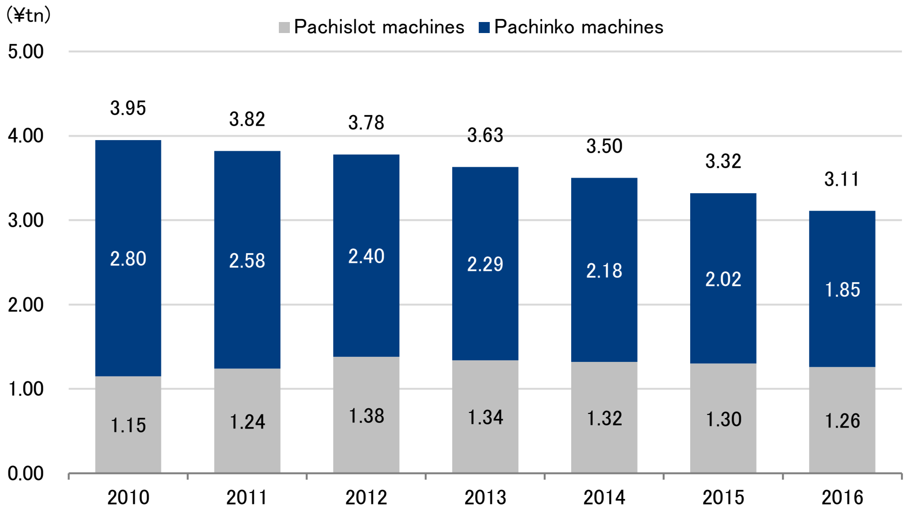


Source: Prepared by FISCO from the Present State of Businesses Affecting Public Morals for each year, Consumer and Environmental Protection Division, Community Safety Bureau, National Police Agency

According to the Company, the value of Japan's combined market for pachinko and pachislot games, as measured by the gross profit earned by all halls nationwide, has fallen each year, similar to the decline in the number of halls. This value has also declined on a per-machine basis. Thus, even though pachinko halls and pachislot halls are increasing in average size, they continue to operate in a challenging business. Additionally, Japan passed the Integrated Resort Facilities Promotion Act* on December 15, 2016. Given this change, the government is promoting measures to deal with gambling and related addictions, a new challenge for the industry. Past curtailment of models with strong gambling features led to temporary customer losses and sustained difficult market conditions for roughly a year. Recent developments are also having a major impact on the industry. However, we think the current situation offers a turning point to hall management that does not rely on gambling, including a weeding out in the industry. The Company expects the market to recover toward ¥4trn in total value over the longer term if Japan overcomes the deflationary economy ahead of the Tokyo Olympic Games. This view takes into account the bottom and subsequent recovery that occurred 2-3 years after the previous earnings downturn.

* It is officially named the "Act on Promoting Development of Areas for Specified Integrated Resort Facilities." The Act stipulates that the government must prepare necessary legal measures to allow for the establishment of integrated facilities with casino, meeting hall, hotel, and other features by private-sector businesses with permits at "specified integrated resort zones" within a year from taking effect. Since its passage, the government has been promoting measures to broadly address gambling and related addictions for public-operated races and pachinko.

Value (gross profit) of Japanese markets for pachinko and pachislot games



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

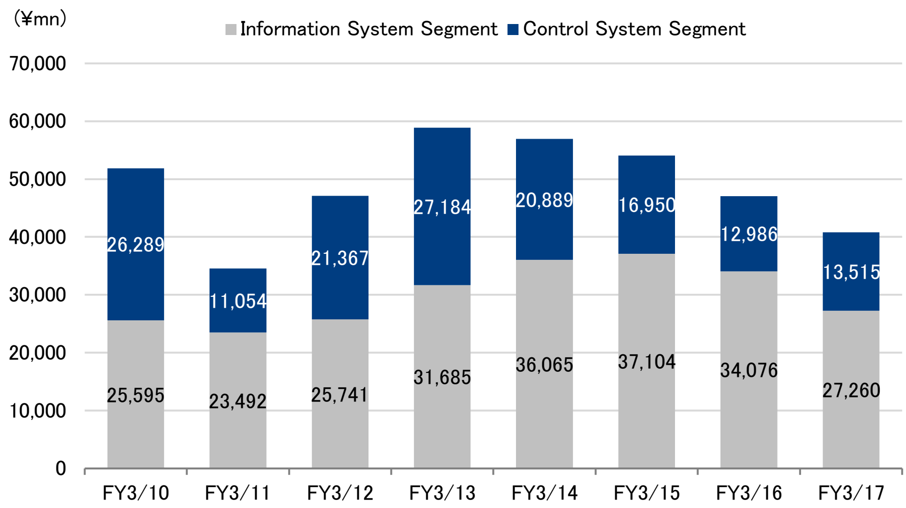
Financial results trends

Aggressively utilizing R&D outlays to develop next-generation products and drive future growth amid contraction of the industry

1. Performance over the past fiscal years

In FY3/11, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake. Its total sales rebounded in FY3/12– FY3/13, even though the pachinko industry continued to contract. This recovery was led by the Information System Segment, which holds high market shares for its products. Sales in this segment reached consecutive record highs in FY3/13–FY3/15, supporting the Company's overall performance. In FY3/16, sales contracted YoY, reflecting the impact of industry restrictions on risky machines and the "collecting and removing."

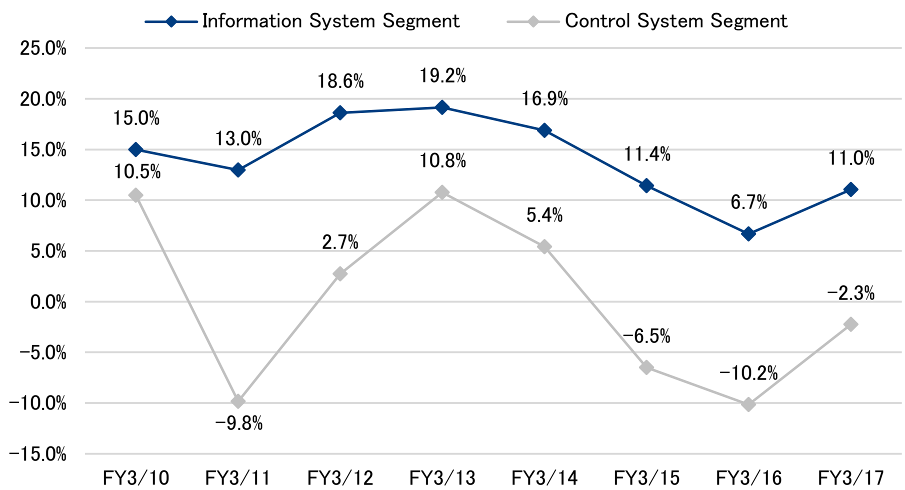
Net sales by segment



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

The Information System Segment provides profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in the development of the next-generation products since FY3/14, profit margins have declined, but considering the size of the investment, margins are still high.

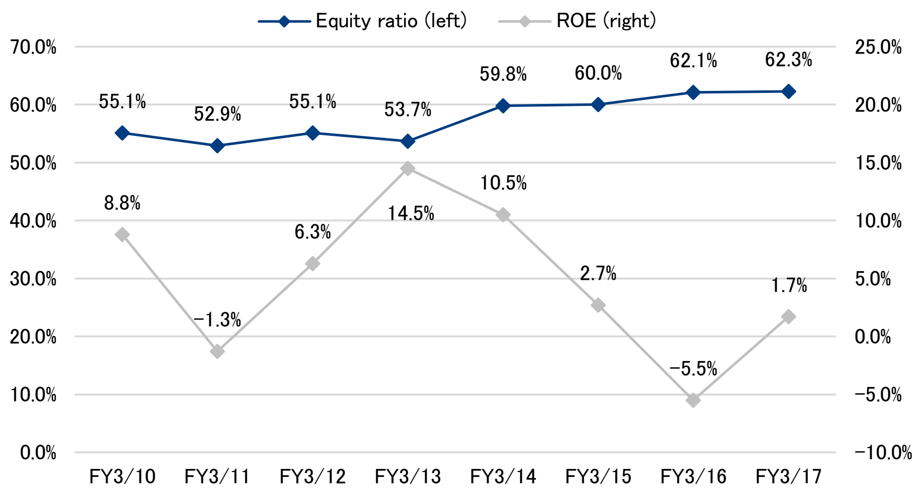
Operating profit margins by segment



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

The Company's equity ratio, a measure of financial stability, has risen, reflecting large retained earnings, reaching 62.3% in FY3/17. The current ratio, which indicates the ability to make payments in the short term, was 181.1% in FY3/17, mainly due to large holdings of cash and deposits. The ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. In FY3/15, the Company suffered a loss due to the bankruptcy of a manufacturer customer. In FY3/16, because of the industry restrictions on risky machines, the Company launched fewer new pachislot machine models than planned, and its sales volume of these machines were far below the planned level. As a result, the Company suffered a loss due to the devaluation of parts and materials for its pachislot machines. (Information on FY3/17 will be updated later)

Equity ratio and ROE



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

Operating profit rose sharply on lower sales in FY3/17 thanks to improved profitability from new product releases and a lull in R&D expenses

2. FY3/17 results

The Company posted sharply higher earnings that restored profits on lower sales in FY3/17 with net sales at ¥40,714mn (-13.4%), operating income at ¥1,048mn (vs. a loss of ¥894mn in the previous fiscal year), ordinary income at ¥1,374mn (vs. a loss of ¥749mn), and net profitable attributable to parent owners at ¥502mn (vs. a loss of ¥1,676mn). Sales missed period-start forecast, while earnings (besides net profit) beat targets.

Sales stalled and undershot forecast in Information System Segment and Control System Segment amid continuation of difficult market conditions, including the impact of collecting and removing of "pachinko machines with a possibility of performance differing from the inspected machine" conducted last year (June-December 2016) (below referred to as "collecting and removing"). In particular, Information System Segment weakened considerably because of decline in new pachinko hall openings and diminished investment appetite for peripheral equipment upgrades. Furthermore, the Control System Segment delivered higher sales than in the previous year, but substantially missed forecast due to revision of sales schedules at amusement equipment firms.

Earnings, meanwhile, improved more than planned owing to decline in the production cost ratio and a steep drop in SG&A expenses. Upbeat sales of new products in the Information System Segment contributed to the lower production cost ratio. Additionally, SG&A expenses fell sharply because of a lull in R&D outlays (including some postponements) versus the previous fiscal year that was the peak in next-generation product development. The Company booked income from dissolution of the insurance reserve fund (¥137mn) as non-operating income. The shortfall that occurred in just net income stemmed from posting an extraordinary loss for impairment charges on content fixed assets related to game software sales at a subsidiary (¥227mn)*.

* The impairment charges take into account recent shortening of the sales period in the games industry and a review of the possibility of future cash flow recovery.

In finances, the capital ratio remained roughly flat and stayed at a high level at 62.3% (vs. 62.1% at the end of the previous fiscal year) as total asset value was down 0.7% from the end of the previous fiscal year to ¥46,828mn on dissolution of the insurance reserve fund and other factors and capital also moved lower by 0.5% to ¥29,151mn because of dividend payments and other items. Furthermore, interest-bearing debt contracted to ¥3,300mn (down ¥2,200mn from the end of the previous fiscal year).

Overview of the FY3/17 results

(¥mn)

	FY3/16 result		FY3/17 result		YoY change		FY3/17 initial forecast		vs. plan	
		Ratio to sales		Ratio to sales		YoY rate of change		Ratio to sales		%
Sales	47,004		40,714		-6,290	-13.4%	50,000		-9,286	81.4%
Information Systems	34,076	72.5%	27,260	67.0%	-6,816	-20.0%	31,000	62.0%	-3,740	87.9%
Control Systems	12,986	27.6%	13,515	33.2%	528	4.1%	19,000	38.0%	-5,485	71.1%
Adjustment	-58	-	-61	-	-2	-	-	-	-61	-
Gross profit	14,279	30.4%	13,953	34.3%	-326	-2.3%	17,200	34.4%	-3,247	81.1%
SG&A expenses	15,174	32.3%	12,904	31.7%	-2,270	-15.0%	16,200	32.4%	-3,296	79.7%
Operating income	-894	-1.9%	1,048	2.6%	1,942	-	1,000	2.0%	48	104.8%
Information Systems	2,277	6.7%	3,011	11.0%	734	32.2%	2,300	7.4%	711	130.9%
Control Systems	-1,319	-10.2%	-306	-2.3%	1,013	-	600	3.2%	-906	-
Adjustment	-1,852	-	-1,656	-	195	-	-1,900	-	-	-
Ordinary income	-749	-1.6%	1,374	3.4%	2,123	-	1,000	2.0%	374	137.4%
Profit attributable to owners of parent	-1,676	-3.6%	502	1.2%	2,178	-	600	1.2%	-98	83.7%
Depreciation cost	1,360		1,661		301	22.1%	1,700		-39	
R&D expense	5,330		3,060		-2,270	-42.6%	4,400		-1,340	
Information Systems	3,965		2,240		-1,725	-43.5%	2,700		-460	
Control Systems	1,365		820		-545	-39.9%	1,700		-880	
Breakdown of segment sales										
Information Systems										
Equipment	23,088		16,698		-6,390		20,285		-3,587	82.3%
Service	10,988		10,562		-426		10,715		-153	98.6%
Control Systems										
Units and components	10,279		8,413		-1,866		10,000		-1,587	84.1%
Pachislot machines and other equipment	2,707		5,102		2,395		9,000		-3,898	56.7%

	End-March 2016 results	End-March 2017 results	YoY change	
				YoY rate of change
Total assets	47,139	46,828	-311	-0.7%
Total equity	29,291	29,151	-139	-0.5%
Equity ratio	62.1%	62.3%	0.2	-

Source: Prepared by FISCO from Company materials

FY3/17 results by segment were as follows.

Information System Segment booked sharply higher earnings on lower sales with net sales down 20.0% YoY to ¥27,260mn and operating profit by segment up 32.2% to ¥3,011mn. Operating profit margin by segment improved substantially to 11.0% (vs. 6.7%). Sales missed forecast, while earnings overshot.

Sales dropped significantly because of decline in new pachinko hall openings and diminished investment appetite for peripheral equipment upgrades amid continuation of a difficult market environment, including the "collecting and removing" impact. While the Company provided conservative forecast in light of the difficult industry environment, actual sales were even lower. Hall computer system sales dropped by 37 units YoY to 76 units (vs. 100 units in initial forecast) and peripheral equipment sales were generally sluggish too.

Key drivers of large upside in operating profit by segment, meanwhile, were upbeat sales of REVOLA, a new information disclosure terminal, at existing customer sites (reaching 120.4% of the plan target) and a 43.5% YoY decline in R&D expenses to ¥2,240mn (just 83.0% of budget). Peaking out of development efforts for the next-generation hall system including peripheral equipment (below, next-generation products) facilitated the decline in R&D expenses. Additionally, sales of MG services, which the Company is promoting as a stable income source, expanded at a healthy pace with an 8.1% YoY increase to ¥4,143mn. While sales continue to shrink due to impacts from the external environment, profitability has been improving in this business.

Control System segment posted higher sales and earnings with net sales up 4.1% YoY to ¥13,515mn and the segment loss down to ¥306mn (from ¥1,319mn in FY3/16). Nevertheless, both sales and earnings missed forecast.

Besides the impact of "collecting and removing," voluntary curtailment of amusement equipment upgrades ahead of the Ise-Shima Summit altered the sales schedules of equipment manufacturers and thereby affected sales too. Significant declines in sales volumes for display units and peripheral parts led to weaker sales in this product area. While sales increased YoY thanks to releases of two in-house developed pachislot models (compared to one model in FY3/16), they missed forecast because of a delay in the release timing of one model.

For earnings, this segment reduced the loss versus the previous year owing to non-recurrence of a one-time setback* and decline in R&D expenses. However, it still posted a loss for a third straight period because of a shortfall in sales.

* Losses related to revaluation of pachinko equipment materials and other items

Sales Volumes in FY3/17

	FY3/16 result	FY3/17 result	YoY change	Updated FY3/17 forecast from the 1H announcement
Sales volumes (Information System Segment)				
Hall computers	113 units	76 units	-37 units	100 units
Call lamps				
BiGMO Series	13,412 units	- unit	-13,412 units	- unit
BiGMO PREMIUM	54,987 units	27,154 units	-27,833 units	40,000 units
REVOLA	- units	48,156 units	48,156 units	40,000 units
IL-X Series	73,020 units	22,638 units	-50,382 units	50,000 units
VEGASIA CR unit	98,009 units	65,862 units	-32,147 units	70,000 units
Face recognition system	12 halls	12 halls	0	15 halls
Sales volumes (Control System Segment)				
Display unit models	13 models	7 models	-6 models	9 models
Units sold	124,770 units	69,937 units	-54,833 units	122,054 units
Pachislot machine models	1 model	2 models	1 model	3 models
Units sold	5,100 units	12,300 units	7,200 units	17,800 units

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

Results outlook

Expects sharply higher earnings on lower sales again in FY3/18, full-fledged launch of next-generation products likely to boost earnings

In FY3/18, the Company forecasts for a similar pattern of vibrant earnings growth on weaker sales with net sales at ¥39,000mn (-4.2%), operating income at ¥1,300mn (+24.0%), ordinary income at ¥1,300mn (-5.4%), and net profit attributable to parent owners at ¥800mn (+59.1%).

The Company expects higher sales in Information System Segment thanks to the new product launches, but downward pressure from significant shrinkage of the Control System Segment. For earnings, meanwhile, it projects a gain in operating profit primarily because of decline in R&D expenses, improved income in the Control System Segment, and other SG&A expense savings.

Company Forecasts for FY3/18

	FY3/17 result		FY3/18 forecast		YoY change	
		Ratio to sales		Ratio to sales		YoY rate of change
Sales	40,714		39,000		-1,714	-4.2%
Information Systems	27,260	67.0%	28,500	73.1%	1,240	4.5%
Control Systems	13,515	33.2%	10,500	26.9%	-3,015	-22.3%
Gross profit	13,953	34.3%	13,400	34.4%	-553	-4.0%
SG&A expenses	12,904	31.7%	12,100	31.0%	-804	-6.2%
Operating income	1,048	2.6%	1,300	3.3%	252	24.0%
Information Systems	3,011	11.0%	2,500	8.8%	-511	-17.0%
Control Systems	-306	-2.3%	700	6.7%	1,006	-
Adjustment	-1,656	-	-1,900	-	-	-
Ordinary income	1,374	3.4%	1,300	3.3%	-74	-5.4%
Profit attributable to owners of parent	502	1.2%	800	2.1%	298	59.1%
Depreciation cost	1,661		1,850		189	11.4%
R&D expense	3,060		2,200		-860	-28.1%
Information Systems	2,240		1,900		-340	-15.2%
Control Systems	820		300		-520	-63.4%

Source: Prepared by FISCO from Company materials

The Company's forecasts by segment for FY3/18 are as follows.

The Information System Segment outlook projects a decline in profit on higher sales with net sales at ¥28,500mn (+4.5% YoY) and operating profit by segment at ¥2,500mn (-17.0%). For sales, the Company factors in income contributions from REVOLA, which has been very well received in the market and is sustaining upbeat momentum from FY3/16, and additions from new products, such as VEGASIA III, a new CR unit*1 that attracted considerable interest in the test deployment, released in June 2017. It also aims to enhance added value in MG services*2, thereby lifting sales 5.0% YoY to ¥4,350mn.

*1 This is a next-generation CR unit with major upgrades from VEGASIA II that gained customer support for its completeness as a CR unit. It offers a variety of feature enhancements, including an ability to ascertain fan trends with standard provision of a face authentication camera and face recognition system in all models.
*2 It has started information provision service that adds face recognition data.

Nevertheless, the Company forecasts lower earnings, even with the prospect of a 15.2% YoY decline in R&D expenses to ¥1,900mn with peaking out of next-generation product development activities, because of one-time impacts from depreciation costs related to beginning sales of new products (one-time depreciation of molds and other items) and an anticipated temporary rise in manufacturing costs.

The Control System Segment outlook envisions sharply higher earnings (and return to profitability) on lower sales at ¥10,500mn in net sales (-22.3% YoY) and ¥700mn in operating profit by segment (vs. a ¥306mn loss in FY3/17). For sales, the Company projects further declines in display unit and peripheral part sales volumes and weaker sales of self-developed pachislot amusement machines even with the release of two models.

In earning, however, it expects a sharp increase and return to profits due to a 63.4% YoY drop in SG&A expenses to ¥300mn and lower sales fees related to self-developed pachislot equipment.

We think the Company places emphasis on strengthening profitability, rather than sales growth, which is easily affected by external environment impacts, amid uncertainty in industry conditions. The sales target appears to be well within reach given likely income contributions from beginning sales of new products in the Information System Segment and conservative assumptions, including the market environment, for the Control System Segment. For earnings, the Company seems to have presented a reasonable target considering new product effects and improved profitability from a lull in R&D costs.

Sales Targets in FY3/18

	FY3/17 result	FY3/18 target	YoY change
Sales volumes (Information System Segment)			
Hall computers	76 units	100 units	24 units
Call lamps			
BiGMO PREMIUM	27,154 units	35,000 units	7,846 units
REVOLA	48,156 units	42,000 units	-6,156 units
IL-X Series	22,638 units	25,000 units	2,362 units
VEGASIA CR unit	65,862 units	70,000 units	4,138 units
Face recognition system	12 halls	45 halls	33 halls
Sales volumes (Control System Segment)			
Display unit models	7 models	13 models	6 models
Units sold	69,937 units	130,000 units	60,063 units
Pachislot machine models	2 models	2 models	0 model
Units sold	12,300 units	5,400 units	-6,900 units

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

Growth strategy

Making progress with the medium-term business plan that lasts through FY3/20, transition to a new team and organizational changes in the new fiscal year

The Company is currently promoting the "Next 50 Chapter One" medium-term business plan that lasts through FY3/20. In FY3/18, the second year of the plan, it moved to a new team, including replacement of the president, to help in addressing sharp changes in the business environment, and altered the organization to strengthen its income structure. Nevertheless, the Company did not change numerical goals or the overall direction. The plan focuses on bolstering the business foundation to help in response to market change (acquiring fans with stronger interest in game features) and pachinko hall management reforms (strategic decision-making based on data analysis) with an outlook of moderate recovery in the market environment over the medium term. The Company intends to enhance growth potential and profitability through expansion of market share with the next-generation hall computer (including peripheral equipment) that it has been aggressively developing and new value creation by leveraging data analysis and planning and development capabilities.

The medium-term plan targets ¥57bn in net sales, ¥4bn in operating income (7% operating margin), and at least 7% ROE in FY3/20, the final year. It also maintains strong investments with cumulative outlays of ¥10bn in R&D expenses, ¥4bn in facilities spending, and ¥5bn in depreciation costs. The Company aims to improve profitability while investing in future growth.

Medium-Term Plan

(¥mn)

	FY3/17 result		FY3/18 forecast		FY3/20 target	
		Ratio to sales		Ratio to sales		Ratio to sales
Sales	40,714		39,000		57,000	
Information Systems	27,260	67.0%	28,500	73.1%	38,000	66.7%
Control Systems	13,515	33.2%	10,500	26.9%	19,000	33.3%
Operating income	1,048	2.6%	1,300	3.3%	4,000	7.0%
Control Systems	3,011	11.0%	2,500	8.8%	5,000	13.2%
Operating income	-306	-2.3%	700	6.7%	1,000	5.3%
Adjustment	-1,656	-	-1,900	-	-2,000	-
ROE	1.7%		-		7.0%	
Sales of MG Services	4,143		4,350		4,900	

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Source: Prepared by FISCO from Company materials

The pachinko and pachislot industry continues to face uncertainties, such as how long “collecting and removing” impact will last and the extent of impact from “measures to deal with additions,” a new challenge. However, the Company possesses a major advantage owing to its aggressive development of a next-generation hall computer, including peripheral equipment. We expect the Company to gauge the timing of the rollout of the next-generation hall computer, the centerpiece of development efforts, in light of response to “measures for dealing with addictions” and market environment trends. It plans to incrementally release peripheral equipment ahead of the rollout. The Company should be capable of realizing sustainable growth, even if the market shrinks, by tapping into replacement demand at existing customer sites with full-fledged operation of next-generation products that offer high added value. Additionally, polarization is likely to proceed further in the pachinko hall industry with survival mainly by firms with extensive capital resources. These conditions are likely to work favorably for the Company in its efforts to increase market control with the next-generation hall computer and raise market share.

The Company has considerable scope to demonstrate its competitive edge in terms of its ability to devote ample time and funds to develop in-house pachislot machines compared with other pachislot machine makers, and its ability to analyze data to develop machines that offer appealing game features. However, rather than fight for share in the current market, we believe that the key to success for the Company is to use its ability to create original value to target new submarkets, such as fans of anime, thereby supporting the growth of the overall market for pachislot machines.

We think sales growth, which is easily affected by the external environment, should be viewed cautiously for the time being, but see opportunities to boost profitability with full-fledged ramp-up of next-generation products and expansion of MG services. From a longer-term perspective, current difficult conditions constitute a process for approaching a stage in which the Company is capable of further utilizing advantages by promoting changes to playing with more emphasis on game features and reorganization of pachinko halls. We also expect growth in the Company’s business over the longer term by leveraging its dominant position and will also be focusing on initiatives to stimulate the overall industry.

Shareholder returns

Likely to lower the dividend in FY3/18 but stay at a high level, still has room to raise the dividend as earnings grow

The Company paid a ¥50 dividend per share (¥10 interim and ¥40 period-end) in FY3/17, on par with the previous fiscal year and in line with initial forecast, putting the dividend payout ratio at 147.0%. In FY3/18, meanwhile, it plans to lower the dividend by ¥10 to ¥40 for the full year (¥10 interim and ¥30 period-end), taking into account uncertainty about the market environment. However, the dividend payout ratio is a strong 73.9% (using forecast) and this indicates that the Company continues to implement a robust dividend policy.

Given the Company's policy of supplementing its minimum dividends with dividends dependent on profits, FISCO foresees the likelihood of increases in annual dividends as the Company's profits grow over the medium term.

To make its shares more attractive to investors and to encourage shareholders to keep their holdings over the medium-to-long term, the Company has just adopted a system of awarding gifts to shareholders. According to this system, all shareholders registered at the end of September will be awarded points that vary depending on the number of shares held (the minimum holding is 100 shares) and the length of time they have been held. These points can be exchanged for food, electronic goods, gifts, and the Company's original goods.

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