

# Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange Frist Section and Nagoya Stock Exchange First Section

6-Aug.-2019

FISCO Ltd. Analyst

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FISCO Ltd.

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

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## Summary

**In FY3/19, sales declined due to the impact of new regulations, but profits rose considerably. The Company released the industry's first AI hall computer "X (Kai)." The Company is aiming to expand market share by helping hall operators boost efficiency and save labor.**

### 1. Business overview

Daikoku Denki Co., Ltd. <6430> (hereafter, "the Company") has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese slot machines) parlors and halls, and the other that develops, produces and sells display and control units for pachinko and pachislot machines. The Company holds the leading market share, approximately 35%, of the Japanese market for hall computers, reflecting an information management method that is the de facto standard for the industry. Furthermore, the industry's leading membership-based information provision service Daikoku Denki Strategic Information System (DK-SIS) to support the operations of pachinko hall associations forms a network of approximately 3,592 pachinko halls and supports the Company's business foundation.

Japan's pachinko market has been shrinking over the years. In response, the Company has been working 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 revenue, and developing in-house developed pachislot game machines. However, with the series of revisions to regulations (including controlled ball payouts and measures against gambling addiction) having brought the industry to a major turning point, current earnings remain difficult due to the impact of uncertainty about the future. In April 2019, the Company transitioned to a new management system (including appointing a new president) in order to respond to the major changes in the business environment. In June 2019, the Company finally released the AI hall computer "X (Kai)," the first of its kind in the industry, as the Company started in earnest on its efforts targeting future business expansion. In addition to helping hall operators improve efficiency and save labor, the Company is aiming to increase its market share and boost profitability.

### 2. FY3/19 results

In FY3/19, the Company's sales were ¥31,166mn (-8.6% YoY), but it recorded sharply higher profits, with operating income up 28.1% YoY to ¥1,527mn. The market environment remains challenging with customers taking a cautious stance on capital investments because of uncertainty about the impact of new regulations.\* The Information System Segment was able to secure sales roughly on par with the previous year by introducing hall computers to large companies and with solid sales of CR units and other products, but the Control System Segment saw a large decline in sales of control units and components due to the revisions to sales plans by amusement machine manufacturers, higher reuse rates, and other factors, amid the low number of new amusement game machine units sold in the amusement machine industry overall. Meanwhile, in terms of profits, the gross margin improved thanks to service revenue growth and high-value-added proposal-based sales, along with other factors. Additionally, SG&A expenses fell significantly due to a lull in R&D expenses, the decline in sales commissions, and other factors, resulting in a higher-than-forecast increase in profits.

\* Partial Revision of Regulations Regarding the Enforcement of the Act on Control and Improvement of Amusement and Entertainment Business, etc., and Regulations Regarding the Certification of Game Machines and Examination of Model officially promulgated on September 4, 2017 with an enforcement date set for February 1, 2018 (details are given below).

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## Summary

**3. FY3/20 forecast**

For FY3/20, the Company is forecasting higher sales and lower profits. Specifically, the Company is forecasting a 9.1% YoY increase in net sales to ¥34,000mn and a 21.5% decline in operating income to ¥1,200mn. An increase in net sales are forecast for both the Information System Segment and the Control System Segment. In the Information System Segment, the Company will launch products equipped with a variety of contents to comply with the new regulations. In particular, with the quick and widespread adoption of the AI hall computer “X (Kai)” used as a base for hall operational management, the Company will gain a foothold on the introduction of new products, and will attract and retain customers. Meanwhile, the Control System Segment plans to create attractive gaming features suitable for the new regulations, and to extend planning and product proposals utilizing new technology for all pachinko game machines. Still, the large decline in profits is expected as a result of factors including core system replacement, exhibits and other sales promotion costs, and depreciation in association with the release of the AI hall computer.

**4. Future strategic direction**

The Company has been promoting a medium-term management plan with FY3/20 as the final year, but because the market environment continues to be more challenging than expected due to a number of external factors (such as a series of regulatory revisions), the Company has lowered its quantitative targets for FY3/20, the final year of the plan. However, there has been no major change in the future direction. The Company is aiming to improve its growth potential and profitability by creating new value utilizing data analysis and planning development capabilities, in addition to increasing market share with next-generation products. While consolidation in the pachinko hall industry is expected, we will pay close attention to how the Company contributes to the revitalization of the pachinko hall industry by attracting and securing customers with the industry's first AI hall computer “X (Kai)” and by providing new value through data utilization.

**Key Points**

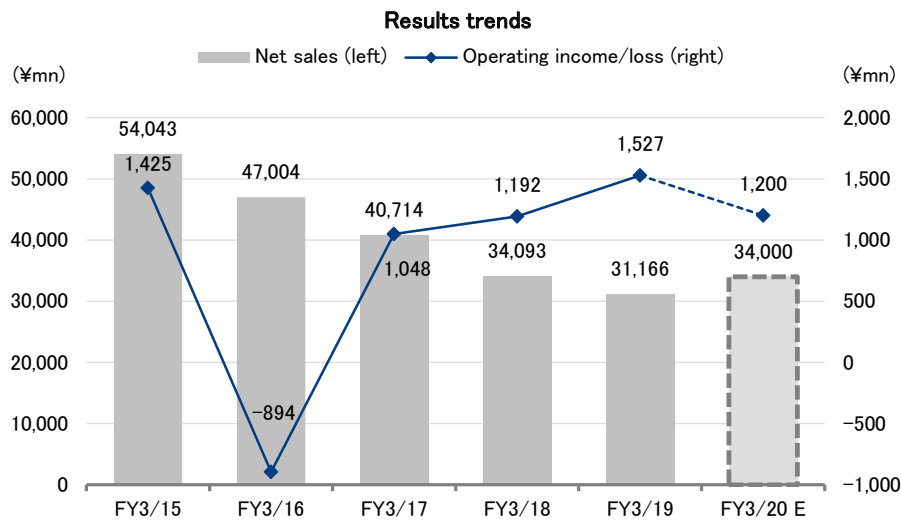
- Reported sharply higher profits in FY3/19 as a result of a lull in R&D expenses and other factors, despite lower sales due to the impact of new regulations
- Forecasting a decline in profits in FY3/20 in conjunction with the increase in depreciation, despite an increase in net sales
- Released the industry's first AI hall computer “X (Kai)” in June 2019
- The Company aims to increase its market share and improve profitability by helping pachinko halls improve their operating efficiency and save labor, as well as by providing new value leveraging data.

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Summary



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

## Description of businesses

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

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

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

The Company's hall computer is utilized at roughly 3,517 halls (giving it a share of about 35.0%) and around 1,873,000 amusement machines are installed (about 43.5% share).

The Company's two main businesses are the Information System Segment and the Control System Segment, but the Information System Segment provided 78.5% of its total sales in the previous fiscal year and has been the main source of stable profit in the past few years.

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

Description of businesses

1. Information System Segment

The Information System Segment offers a complete line of information equipment and services necessary to support operational management at pachinko halls. It sells hall computers, which are the core of the system used at pachinko halls, and peripheral equipment, such as prize management systems and information disclosure systems. The segment also offers hall management support services through information equipment and the membership-based information provision service DK-SIS, 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 computers display the operating conditions and sales of each machine in a hall. These computers are supported by peripheral equipment, such as prize management system and information disclosure system. They also serve as the foundation of the membership-based information provision service. Introducing a hall computer provides the advantage that peripheral equipment and support services can be sold as a package deal. The Company has been aiming to transition to a business model that provides recurring revenue by collecting membership fees such as its aftersales management support services and information provision service in addition to information equipment sales.

In June 2019, the Company finally released the industry's first AI hall computer "X (Kai)" for the first time in 12 years. Based on the concept of a "hall computer that teaches," the main feature of this AI hall computer is that it will guide pachinko hall operators to the optimal solutions by utilizing the Company's big data and having AI automatically analyze the data. By helping pachinko hall operators improve their operating efficiency and save labor, the Company aims to expand its market share and increase its profitability.

Hall computers and main peripheral equipment



Source: The Company's results briefing materials

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## Description of businesses

**2. Control System Segment**

The Control System Segment produces and sells displays and control units, as well as components used for pachinko and pachislot machines for amusement equipment manufacturers. Applying the knowledge obtained from analyzing data from pachinko machines as a hall computer manufacturer for many years, the segment serves as a development partner for the content as well, moving beyond the scope of a machine manufacturer by proposing specs based on the trends of popular models and acquiring copyrights for popular characters.

Since FY3/14, the Company's consolidated subsidiary Daxel Co., Ltd. has been producing and selling pachislot machines developed by Daikoku Denki under the Daxel brand name. However, from FY3/19, the development plans were revised based on the market environment and other factors, and the Company is taking a cautious stance.

 **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 necessity for information disclosure. Thus, it has been able to provide added value from various aspects to management of pachinko halls.

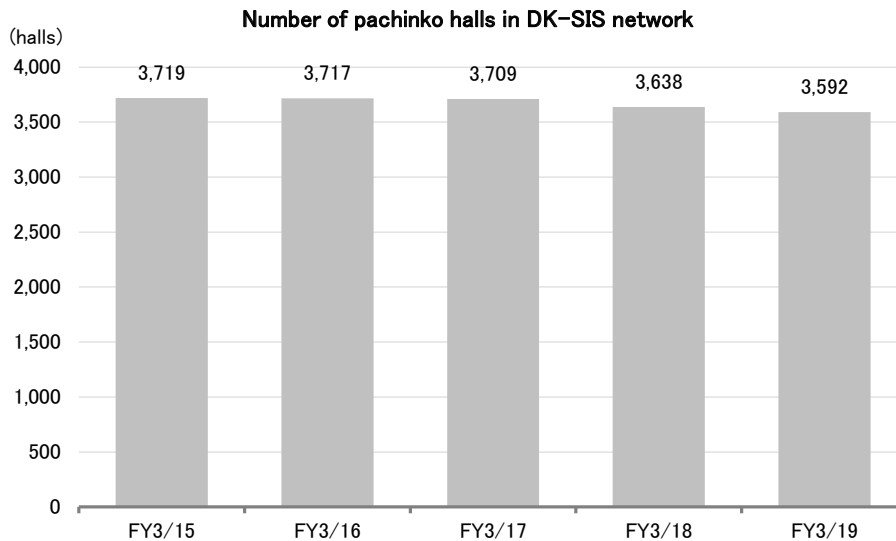
Launched in 1974, the Company's first hall computer enabled the managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic data, but with the introduction of hall computers, data-based hall management became the de facto standard. In subsequent years, the Company has been introducing information equipment with revolutionary functions which is the first of its kind in the pachinko industry consecutively. One such piece of equipment was the Data Robo terminal, which provides information about different models of pachinko and pachislot machines to the players of these machines. This equipment has increased the satisfaction of pachinko players and the efficiency of pachinko hall management, and hereby improved the profitability of pachinko halls.

In June 2019, the Company released the industry's first AI hall computer "X (Kai)." This AI hall computer will greatly help pachinko hall operations, for which shortage of manpower is an issue, by improving operating efficiency and reducing necessary labor by having AI automatically analyze big data that the Company possesses.

Company strengths

**2. Strong network of pachinko halls**

Another advantage the Company has is its membership-based information provision service, DK-SIS. This service creates an information network connecting the Company and member pachinko halls, and processes and analyzes the daily operational information of pachinko halls recorded by hall computers and gives feedback to hall managers to help their operations. It enables the managers to conduct effective hall operation utilizing valuable external information, including nationwide pachinko machine information and operational data broken down by machine model. At the same time, this strong network made up of members also supports the Company's business foundation. Additionally, it occupies an industry think-tank role and contribute to improve the Company's brand as a leading company, and utilized to its strategic proposal and sales activities to amusement equipment manufacturers. Membership totaled 3,592 halls at the end of March 2019 with 1.47mn managed machines (34.3% share in managed machines) and ¥9.1tn in data scale (annual sales). While member volume has peaked amid a recent decline in overall pachinko halls, DK-SIS enjoys a large share in managed machines, mainly at large sites.



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 eyeing future growth, including its R&D expenditure. Over the past few years, the Company has developed unique pachislot machines, a next-generation hall computer (and peripheral equipment), and other products to drive its sales and profit growth hereafter. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, the management support services (hereafter, "MG services") which have been promoted by the Company as a recurring revenue business model have grown and enabled funding of R&D at a high level while maintaining stable segment operating income, and investment risk has been limited. The Company's ability to balance large profits from its existing businesses with heavy investment in businesses for the future growth allows it to produce value on a continuing basis. The Company revised its "next-generation system" development plan for FY3/18 onwards and R&D expenses are declining because of a lull in its costs.

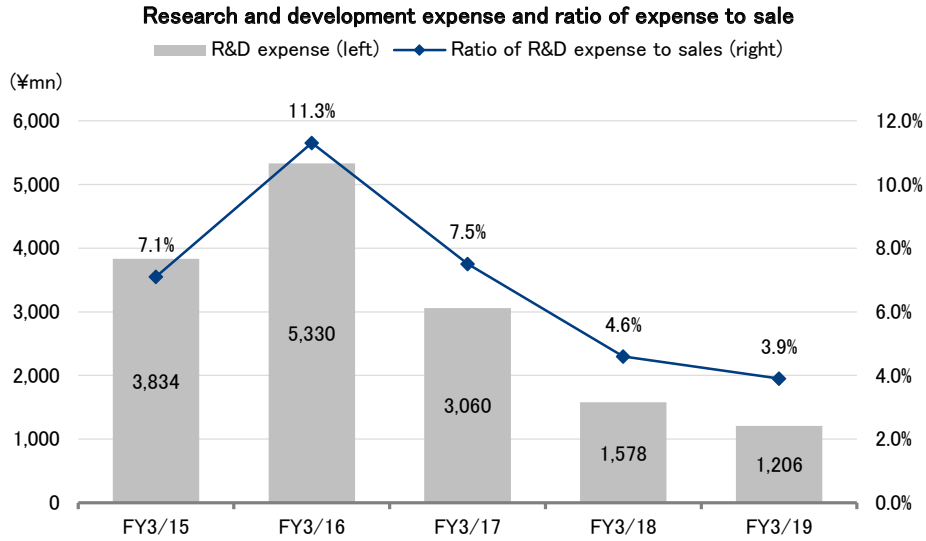


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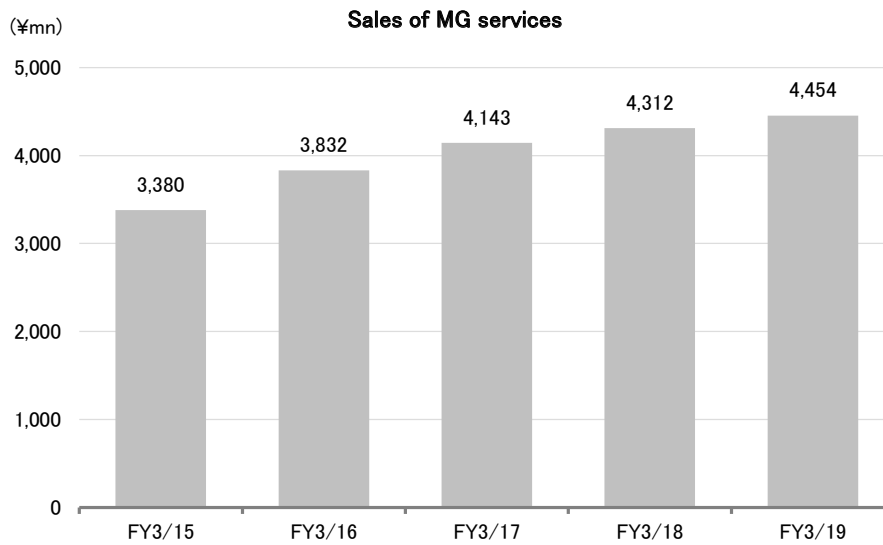
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Company strengths



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



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## Industry environment

**The industry is approaching a major turning point with the impact of new regulations and other factors. While the outlook remains uncertain in the near term, we see opportunities for growth over the medium term**

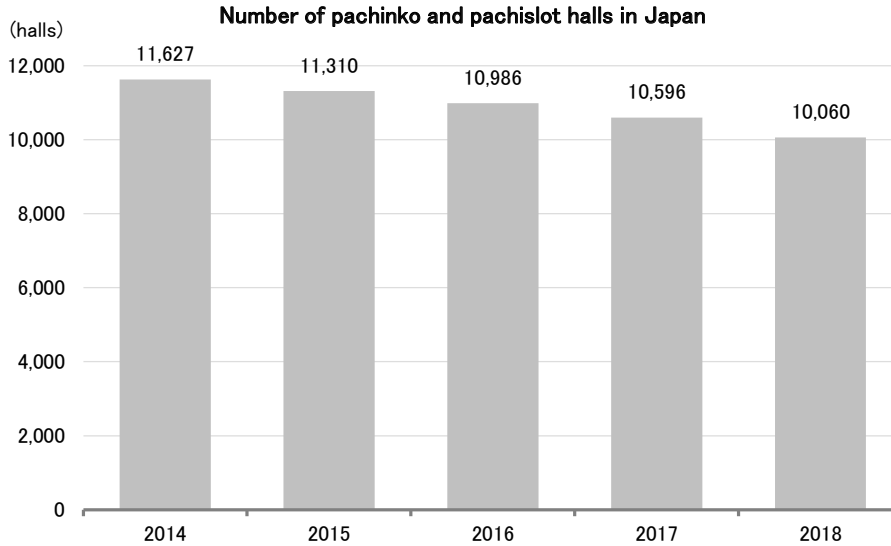
Japan's pachinko industry has been shrinking for years, reflecting a decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The self-regulatory action taken by the industry in 2015 (tightening restrictions on both pachinko and pachislot machines with strong gambling elements) left the whole industry in a slump in 2016 as it started to grapple with the problem of collecting and removing all pachinko machines that may perform differently from certified standards. Since the Regulations Regarding the Certification of Game Machines and Examination of Model (enforced on February 1, 2018, hereafter, "new regulations") were officially announced on September 4, 2017, the industry has remained in a state of flux due to a pessimistic view and uncertainty toward the industry. While amusement equipment manufacturers is announcing pachinko machines with a settings feature which is capable of setting the probability of major wins at up to six levels and type-6 pachislot machines as amusement machines that comply with new regulations, the industry has not begun full-fledged deployment yet due to the limited number of certified models at this stage and undecided market assessment of certified models. However, we expect increased investments by halls targeting survival (customer draw) amid market releases of new-standard machines as the industry advances in removal of former-standard machines. Manpower shortages have worsened for hall operations too. This is likely to spur deployment of facilities and equipment that provide labor savings.

\* Among the new regulations are restrictions on the maximum number of balls that can be paid out and clearly defined standards for "controlled machines." However, although more than one year has passed since the enforcement of the new regulations, there are still a large number of machines based on the old regulations. Pachinko hall operators are worried that their earnings will decline and they will be faced with difficult decisions about the timing of equipment replacement and other matters. This has likely prolonged their diminished investment appetite (cautious stance).

According to surveys by the National Police Agency, the number of pachinko halls in Japan declined at an average annual rate of 2.7% from 2011 to 2018. In particular, there is a noticeable decline in new hall openings due to the impact of the new regulations and other factors. In 2018, the number of halls was 10,060 (down 536 YoY). It is estimated that the Company served about 3,517 of these halls based on the fact that it held approximately 35% of the Japanese market for hall computers. The Company's customer halls are often high-end, large pachinko halls that are the top performers in their respective local market which exceed the market average in size\*. Average amusement machine volume per store is 533 machines, surpassing the average at other companies (371 machines) by about 40%. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. We expect an excellent opportunity for the Company to expand business once investment appetites recover mainly at large halls (after uncertainty fades and market activity picks up).

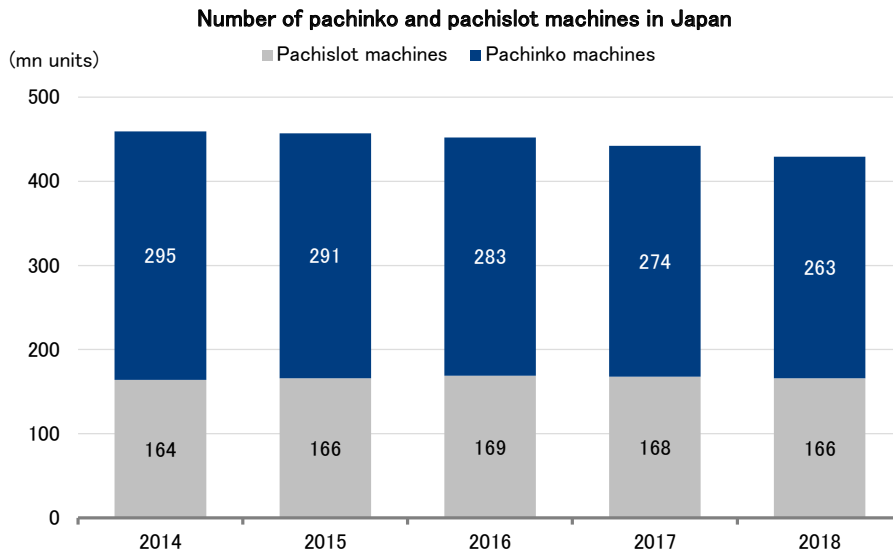
\* The Company holds a roughly 54.2% share in mid-sized to larger sites (501 to 1,000 machines) and around 75.0% in large sites (1,001 or more machines). Its market presence is higher at large sites.

Industry environment



Source: Prepared by FISCO from the Present State of Public Moral Environment and Crimes Related to Public Morals for each year and other information from the Community Safety Bureau, Safety Division, National Police Agency

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



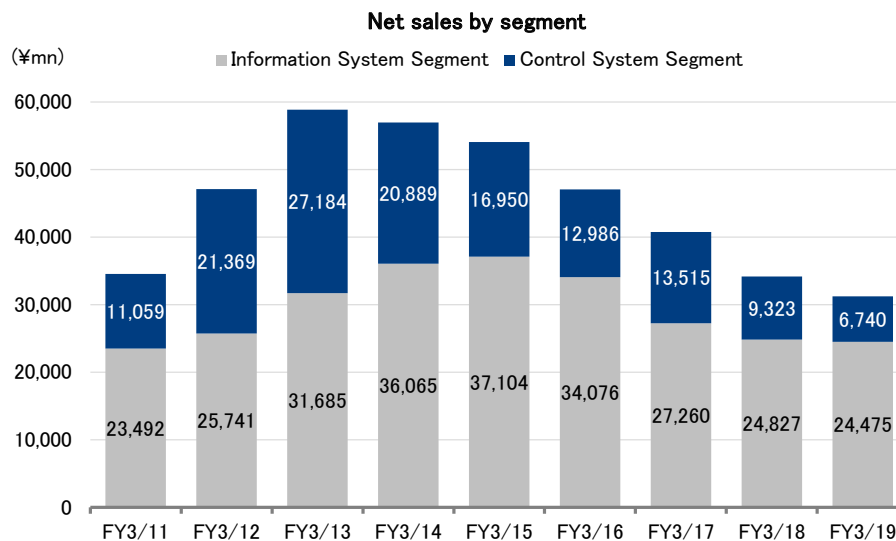
Source: Prepared by FISCO from the Present State of Public Moral Environment and Crimes Related to Public Morals for each year and other information from the Community Safety Bureau, Safety Division, National Police Agency

## Financial results trends

### Actively invest in R&D aimed at future growth, even amidst weak performance trends while the industry moves towards a transitional phase

#### 1. Performance over the past fiscal years

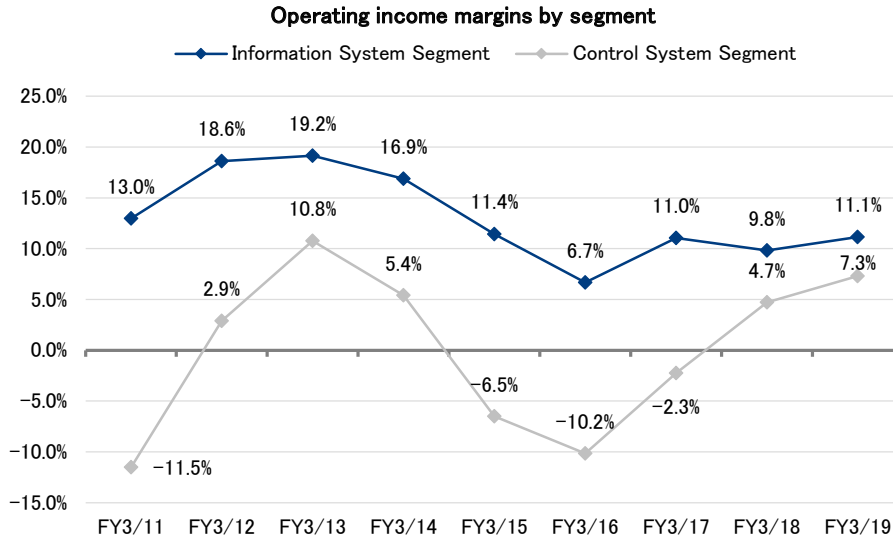
Looking back on the performance in the past nine fiscal years, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake in FY3/11. Its net sales rebounded in afterwards, even though the pachinko industry continued to contract. This recovery was mainly led by the Information System Segment, which holds high market shares for its products. Sales in this segment reached consecutive record highs in FY3/13-FY3/15, supporting the Company's overall performance. However, sales have been contracting since FY3/16 (a decline in sales for the sixth consecutive fiscal terms) due to various negative external factors, such as voluntary industry regulations, retrievals and removals of risky machines, and uncertainty related to new regulations.



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

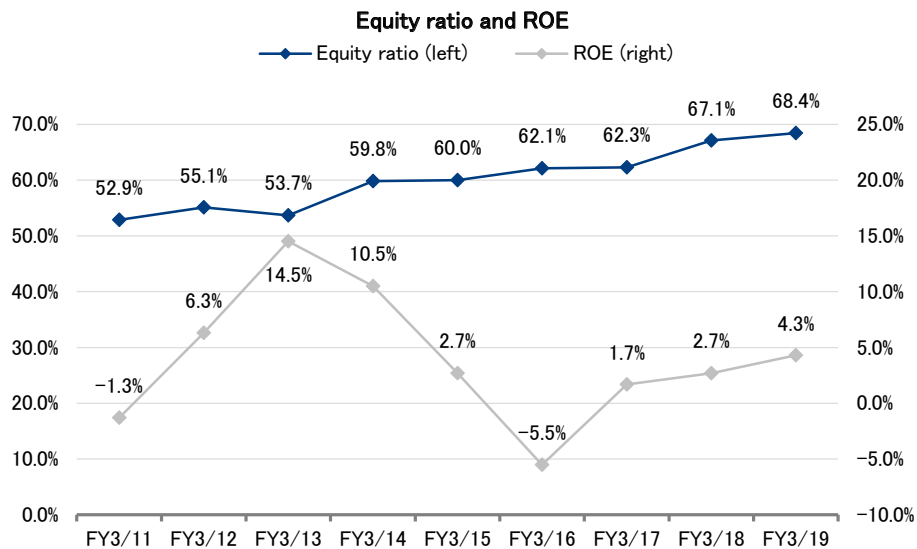
The Information System Segment becomes the source of profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in R&D for next-generation products since FY3/14, profit margins have declined, but considering the size of the investment, margins are still high. In particular, steady progress in conversion to a recurring-income business model, such as growth in MG service business, has been supporting income.

Financial results trends



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 68.4% in FY3/19. The current ratio, which indicates the ability to make payments in the short term, was 213.9% in FY3/19, 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 was 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. However, conditions have been gradually recovering recently.



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

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Financial results trends

## Profits rose sharply, despite a sales decline from the impact of new regulations, in FY3/19 as a result of contributions to higher profits from growth in service sales and a lull in R&D spending

### 2. Overview of FY3/19 results

In FY3/19, the Company recorded sharply higher profits despite of a decline in sales, posting net sales of ¥31,166mn (-8.6% YoY), operating income of ¥1,527mn (+28.1%), ordinary income of ¥1,748mn (+25.8%), and net income attributable to owners of the parent of ¥1,263mn (+60.9%). Sales came in below the Company's initial forecast but earnings finished well above.

Despite more than a year having passed since the enforcement of the new regulations, the market environment remains challenging as pachinko hall operators continue their cautious stance towards capital investment. Amid this environment, the Information System Segment is expected to secure sales almost on par with the previous fiscal year, due to the deployment of hall computers to large companies and the steady sales of CR units. On the other hand, in the Control System Segment, sales significantly undercut the forecast due to the decline in sales of control units and components due to the revisions to sales plans by amusement machine manufacturers, higher reuse rates, and other factors, amid the low number of new amusement machine units sold in the industry overall.

In profits, gross margin increased by 2.8 percentage points YoY to 37.5%, thanks to growth in service revenue and high-value-added proposal-based sales among other factors. Additionally, SG&A expenses fell significantly on a lull in R&D expenses, the decline in sales commissions, and other factors. As a result, operating income increased significantly, surpassing the forecast. The Company's operating margin improved to 4.9% (compared to 3.5% in FY3/18).

In terms of financial conditions, total assets increased 0.4% from the end of FY3/18 to ¥43,729mn, which was roughly unchanged, while equity increased a small 2.2% to ¥29,898mn, due to the accumulation of retained earnings. As a result, the equity ratio was 68.4% (compared to 67.1% at the end of FY3/18), a minor improvement.

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## Financial results trends

**Overview of FY3/19**

	FY3/18		FY3/19		Change		FY3/19		vs. forecast	
	Results	Ratio to sales	Results	Ratio to sales	% change	Initial forecast	Ratio to sales	Achievement rate		
Net sales	34,093		31,166		-2,926	-8.6%	35,000		-3,834	89.0%
Information System Segment	24,827	72.8%	24,474	78.5%	-352	-1.4%	26,000	74.3%	-1,526	94.1%
Control System Segment	9,322	27.3%	6,740	21.6%	-2,582	-27.7%	9,000	25.7%	-2,260	74.9%
Adjustment	-56	-	-49	-	7	-	0	-	-49	-
Gross profit	11,837	34.7%	11,673	37.5%	-164	-1.4%	12,400	35.4%	-727	94.1%
SG&A expenses	10,644	31.2%	10,145	32.6%	-499	-4.7%	11,100	31.7%	-955	91.4%
Operating income	1,192	3.5%	1,527	4.9%	335	28.1%	1,300	3.7%	227	117.5%
Information System Segment	2,435	9.8%	2,725	11.1%	290	11.9%	2,400	9.2%	325	113.5%
Control System Segment	433	4.7%	488	7.2%	54	12.7%	800	8.9%	-312	61.0%
Adjustment	-1,676	-	-1,686	-	-9	-	-1,900	-	214	-
Ordinary income	1,390	4.1%	1,748	5.6%	358	25.8%	1,400	4.0%	348	124.9%
Net income attributable to owners of the parent	785	2.3%	1,263	4.1%	478	60.9%	800	2.3%	463	157.9%
Depreciation	2,085		1,742		-343		1,870		-128	93.2%
R&D expense	1,578		1,206		-372	-23.6%	1,600		-394	
Information System Segment	1,470		1,124		-346	-23.5%	1,380		-256	
Control System Segment	108		82		-26	-24.1%	220		-138	
<b>Breakdown of segment sales</b>										
<b>Information System Segment</b>										
Equipment	14,413		13,871		-542					
Service	10,414		10,603		189					
<b>Control System Segment</b>										
Units and components	6,261		5,427		-834					
Pachislot machines and other equipment	3,062		1,313		-1,749					
		FY3/18 Results		FY3/19 Results	YoY change					
						% change				
Total assets		43,564		43,729	165	0.4%				
Total equity		29,251		29,898	646	2.2%				
Equity ratio		67.1%		68.4%	1.3%	-				

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

The results by segment were as follows.

**(1) Information System Segment**

Profit rose on lower sales, with sales falling 1.4% YoY to ¥24,474mn and segment income increasing 11.9% to ¥2,725mn. Sales fell slightly short of the initial forecast while profits were much higher than expected. Amid the large decline in new pachinko hall openings and major renovations, sales of hall computers increased due to progress in introductions at major companies. Sales of information disclosure terminals\* were roughly on par with the previous fiscal year. However, overall sales fell slightly due to the decline in sales of prize management systems and other key products.

\* Sales of information terminals (call lights) for fans such as "BIGMO PREMIUM II" and "REVOLA," and of CR units such as "VEGASIA III," whose security offering, unique to our company, was highly regarded, were at the levels of the previous consolidated fiscal year.

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## Financial results trends

As explained above, profit rose sharply and surpassed the forecast on the growth in highly-profitable service sales and high value-added proposal sales to existing halls which helped to improve gross margin, as well as a lull in R&D expenses for next-generation hall computers and other products.

Furthermore, despite weakness in overall equipment sales, service sales steadily improved 1.8% YoY to ¥10,603mn (including an increase of 3.3% YoY to ¥4,454mn in sales for the MG service, to which the Company is particularly focusing its efforts) and are contributing to profit stability.

**(2) Control System Segment**

Sales declined 27.7% YoY to ¥6,740mn and segment income increased 12.7% to ¥488mn, though both undershot the initial forecast. Sales of display units for pachinko amusement equipment were solid. However, sales of control units and components declined because of revisions to sales plans by amusement equipment manufacturers due to the impact of new regulations, a rise in the reuse rate, and other factors. The absence of sales of in-house developed pachislot machines\* was also a factor behind the decline in sales.\*

\* Approximately 5,500 units were sold in FY3/18

The decline in earnings due to the drop in sales resulted in profits falling short of the forecast.

**Sales volume in FY3/19**

	FY3/18	FY3/19	YoY change
Sales volume (Information System Segment)			
Hall computers	64 units	84 units	20 units
Call lamps			
BIGMO PREMIUM	34,275 units	32,686 units	-1,589 units
REVOLA	32,771 units	32,972 units	201 units
IL-X series	32,265 units	18,887 units	-13,378 units
VEGASIA CR unit	53,600 units	52,711 units	-889 units
Facial recognition system	34 units	40 units	6 units
Sales volume (Control System Segment)			
Display unit models	6 models	12 models	6 models
Units sold	51,106 units	73,693 units	22,587 units
Pachislot machine models	2 models	0 models	-2 models
Units sold	5,500 units	0 units	-5,500 units

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

Looking back at FY3/19 results in light of these trends including an impact by new regulations, sales dropped amid an ongoing tough market environment with steep declines in new hall openings and major renovations, but we have a favorable view of the Company having started business transactions with leading companies and achieving a large increase in profit due to the improvement in the gross margin as a result of growth in service revenue and proposal-based sales, as well as a lull in R&D expenses, along with other factors. We also think the strong situation with orders of VEGASIA III, a CR unit that includes innovative new services, is positive news going forward.

\* The most distinguishing feature of VEGASIA III is its built-in facial recognition camera that allows pachinko hall managers to get a good handle on player trends. In particular, customers have highly praised the realization of ideal model composition through data analysis and enhanced security features.



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## ■ Outlook

### **The FY3/20 forecast is for higher sales but lower profits due to depreciation and other factors. The Company aims for the early, widespread adoption of the industry's first AI hall computer**

For FY3/20, the Company forecasts an increase in sales but a decrease in profits, with net sales at ¥34,000mn (+9.1% YoY), operating income at ¥1,200mn (-21.5%), ordinary income at ¥1,250mn (-28.5%), and net income attributable to owners of the parent at ¥800mn (-36.7%).

The Company is forecasting higher sales in both the Information System Segment and the Control System Segment. In the Information System Segment, the Company will launch products equipped with a variety of contents complying with the new regulations. In particular, with the June 2019 release of the AI hall computer "X (Kai)"\* used as a base for hall operational management, the Company will gain a foothold on the introduction of new products and attract and keep customers. Meanwhile, the Control System Segment plans to create attractive gaming features suitable for the new regulations, and to extend planning and product proposals utilizing new technology to all pachinko game machines.

\* The Company initially planned to release it as a product system accompanied by hardware, but in order to ensure a quick, widespread adoption with users curbing initial investments, the Company changed course and made it so that it could be used with a system upgrade to an existing hall computer. As a result, we can expect earnings to decline more than forecast in the short term, but over the medium to long term we can expect an increase in sales of MIRAIGATE services due to higher market share (increase in stable earnings).

Meanwhile, the forecasted large decline in profits is due to replacements of core systems, sales promotion costs, as well as depreciation in conjunction with the release of the AI hall computer "X (Kai)."

While difficult market conditions will continue, we think that the Company can achieve its results forecasts because of gradual activation of replacement demand for peripheral equipment aimed at attracting customers as amusement machines that comply with the new regulations enter the market, positive results in high value-added proposal sales mainly targeting large chains with sufficient capital, growth in orders for new products equipped with innovative features, a surge in demand ahead of the consumption tax rate hike, and other factors. On the other hand, concerns include the fact that approximately 180,000 pachislot machines are expected to be replaced by December 2019 (the certification of machines based on old regulations will expire), and in conjunction with this there is a possibility that investments in the Company's products (peripheral equipment, etc.) will be put off. Still, the Company has conservatively factored the impact of this into results forecasts.

The biggest focus of attention will be on how the Company can quickly get the AI hall computer "X (Kai)" to be used on a widespread basis, targeting business growth in FY3/21 and beyond. The Company's unique data utilization contributes to more efficient and labor-saving hall operations management, and this leads to solving manpower shortages and cost reductions, while the change to a delivery system that lowers users' initial costs could also provide significant support for early adoption. In addition, if the Company can make progress in attracting and keeping customers, especially with large companies (increased market share), this would likely provide a foothold for sales of new products equipped with innovative features. Accordingly, we will keep a close watch on progress made with respect to expanding market share and enhancing profitability.

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## Outlook

**FY3/20 forecast**

	FY3/19		FY3/20		YoY change	
	Result	Ratio to sales	Forecast	Ratio to sales	% change	
Net sales	31,166		34,000		2,834	9.1%
Information System Segment	24,474	78.5%	26,000	76.5%	1,526	6.2%
Control System Segment	6,740	21.6%	8,000	23.5%	1,260	18.7%
Gross profit	11,673	37.5%	12,100	35.6%	427	3.7%
SG&A expenses	10,145	32.6%	10,900	32.1%	755	7.4%
Operating income	1,527	4.9%	1,200	3.5%	-327	-21.4%
Information System Segment	2,725	11.1%	2,500	9.6%	-225	-8.3%
Control System Segment	488	7.2%	700	8.8%	212	43.4%
Adjustment	-1,686	-	-2,000	-	-	-
Ordinary income	1,748	5.6%	1,250	3.7%	-498	-28.5%
Net income attributable to owners of the parent	1,263	4.1%	800	2.4%	-463	-36.7%
Depreciation	1,742		2,380		638	36.6%
R&D expense	1,206		1,210		4	0.3%
Information System Segment	1,124		1,050		-74	-6.6%
Control System Segment	82		160		78	95.1%

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

## Future strategic direction

### In addition to increasing market share with the AI hall computer “X (Kai),” the Company aims to solidify an earnings structure unaffected by the market environment

The Company has been promoting a medium-term management plan with FY3/20 as the final year. However, because the market environment continues to be more challenging than expected due to a number of external factors (such as the series of regulatory revisions), and negative impacts on near-term results due to the change in the approach to delivering the next-generation hall computer (the switch to a delivery approach that will keep users' initial costs down), the Company lowered its quantitative targets\* for the final fiscal year of the medium-term management plan (FY3/20). (Refer to the FY3/20 results forecast for revised quantitative targets.)

\* The Company presented FY3/20 goals of ¥57.0bn in net sales, ¥4.0bn in operating income, and at least 7.0% ROE.

However, there has been no major change in the future direction. The Company is aiming to improve its growth potential and profitability by creating new value utilizing data analysis and planning and development capabilities, in addition to increasing market share with the AI hall computer “X (Kai)” and next-generation products.

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## Future strategic direction

**1. Information System Segment**

The pachinko market's appetite for new investments is likely to remain depressed for at least a while longer. However, equipment demand is gradually stirring due to replacement of game machines in response to the new regulations, and Daikoku Denki intends to develop new products and services that will help it bring in new players, and increase its market share, while maintaining the flexibility needed to respond to changing market conditions. More specifically, the Company has set forth three key measures, as detailed below.

- (1) As before, the Company plans to work at growing its market share and transforming its earnings structure by increasing sales of CR units, information disclosure terminals, and other equipment and an expansion of MG services. Through the provision of MG services in particular, the Company will provide assistance to increase competitiveness and reduce labor costs for pachinko hall operators, and secure its customer base while stabilizing its own sales and earnings.
- (2) The Company plans to make timely introductions of new products and services that have the flexibility needed to meet the changing needs of the market following the new regulations. The Company will also be looking to take advantage of the business opportunities created by the changes in the industry by developing new products and services that will help attract new players (winning back former players as well as attracting new players) including the expansion of various services to provide information to players.
- (3) The Company will reform its business model by deploying the AI hall computer "X (Kai)" that comply with the new regulations in the market and promoting its widespread use, and by continuing to promote investment aimed at helping pachinko hall operators boost efficiency and save labor.

**2. Control System Segment**

In addition to a growing demand for reduced development costs for pachinko and pachislot machines, demand for proposals to cope with environmental changes in market in the future and product planning is becoming increasingly important in the current market environment. In response, Daikoku Denki intends to closely coordinate the efforts of its Control System and Information System segments in order to further differentiate itself from competitors, assure rapid response to changes in the market environment, and raise operating efficiency. Towards this end, the company has laid out three specific measures it intends to implement, as outlined below.

- (1) Contribute to the healthy operations of pachinko halls by emphasizing the entertainment aspect, and focus on revitalizing the game environment through creation of games that comply with new rules.
- (2) Promptly respond to the requests of game machine manufacturers, reduce in-house costs, ensure fast development, and build a stronger quality assurance system, as well as contribute to shortening customers' development period, reduce costs, and improve quality.
- (3) Utilize Information System Segment's DK-SIS data and Fan-SIS data to help implement project proposals that will create new "game value" and help expand business territory.

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## Future strategic direction

Even though the pachinko industry is approaching a major turning point and this is weighing heavily on near-term performance, over the medium to longer term, we believe the years Daikoku Denki has spent actively developing next-generation hall computers and related peripheral equipment will give it a major advantage over competitors. In particular, we see the Company's MG services and value proposal through its unique services and data analysis as putting it in a strong position to meet the changing needs of the industry. Even assuming the pachinko market continues to contract for a while longer, we believe it will be possible for Daikoku Denki to sustain growth with the help of a full-scale rollout of a high value-added lineup of next-generation products that will capture the replacement demand of existing pachinko hall operators. 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 industry's first AI hall computer "X (Kai)" and raise market share.

We believe it is necessary to cautiously assess sales growth, which is readily affected by the external environment, for the time being, but are focusing on improvement in profitability through development of products and services that respond to changes in the market environment and expansion of MG service. From a medium to longer term perspective, we also anticipate growth for the Company that leverages its dominant position and initiatives seeking to bolster the overall industry. We intend to monitor Company's activities that directly engage with pachinko and pachislot fans, amusement fans, and new fan segments (including provision of member information via a smartphone app and initiatives that bring people to halls) as well as with pachinko halls and amusement equipment manufacturers.

## Shareholder returns

### **Plans to pay a ¥40 annual dividend in FY3/20 (same as in FY3/19); likely to have room to raise the dividend over the medium-term accompanying profit growth**

In FY3/19, the Company decided the annual dividend of ¥40 per share for the full year (¥10 interim and ¥30 year-end) as the initial forecast. The Company plans to pay a ¥40 annual dividend in FY3/20 (¥10 interim, ¥30 year-end), the same as in the previous fiscal year.

Given the Company's policy of supplementing its minimum dividends with dividends dependent on earnings, 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 adopted a system of awarding gifts to shareholders. Shareholders (owning 100 or more shares) as of September 30 each year receive points that can be exchanged with products (such as food, beverages, electronic equipment, travel or experiences, or donations to social contribution activities) in accordance with the number of shares owned and length of ownership. The Company's IR official explains that this program has been highly praised by individual shareholders.



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