

Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange First Section and Nagoya Stock Exchange First Section

16-Feb.-2022

FISCO Ltd. Analyst

Ikuo Shibata



FISCO Ltd.

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

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Summary

Posted higher sales and significantly stronger profits in 1H FY3/22. Disclosed a medium-term management plan that begins in FY3/23 and addresses the smart gaming machine era; aims to build the industry's only platform based on a cloud server

1. Business overview

Daikoku Denki Co., Ltd. <6430> (hereafter, "the Company") has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese slot machines) parlors and halls, and the other that develops, produces and sells display and control units for pachinko machines. The Company holds the leading market share, approximately 36.6%, of the Japanese market for hall computers, reflecting an information management method that is the de facto standard for the industry. Furthermore, the industry's leading membership-based information provision service Daikoku Denki Strategic Information System (DK-SIS) facilitating the operations of pachinko hall associations forms a network of 3,337 pachinko halls and supports the Company's business foundation.

With the pachinko market on a trend of steady annual shrinkage, the Company is striving to increase market share at large halls and promoting business reforms, including a shift to a business model with recurring revenue that continues over time, from a medium to long term perspective. However, with the series of revisions to regulations (including controlled ball payouts, measures against gambling addiction, and replacement with machines complying with the new regulations) having brought the industry to a major turning point, earnings right now remain difficult due to the impact of future uncertainty, along with the impact of the COVID-19 pandemic. Meanwhile, despite the approaching deadline for replacing machines complying with the former regulations at the end of January 2022, the gaming machine market is showing signs of an upswing driven by pachinko machines that meet the new regulations, and this trend is contributing to recovery in the Company's recent results.

2. Overview of 1H FY3/22 results

The Company posted 1H FY3/22 results with higher sales and significantly stronger profits*, including ¥12,047mn in net sales (+8.5% YoY) and ¥863mn in operating income (¥185mn loss in the previous period). Even compared to the initial outlook, while net sales were roughly on track with the plan, earnings substantially outpaced targets. Pachinko halls have been refraining from new openings and other large-scale capital investments. Nevertheless, upbeat operation of pachinko machines that meet the new regulations and healthy sales of mainstay REVOLA and VEGASIA products in the Information System Segment contributed considerably to higher sales. In earnings too, the Company realized a steep increase in operating income thanks to the profit boost from higher sales and recovery in recurring-revenue business from MIRAIGATE Services (hereinafter, "MG Services") and cost reductions. Main sources of large upside versus the initial outlook were growth in mainstay products with high profitability and success in initiatives to lower companywide costs (such as work improvements like workstyle reforms and promotion of increased efficiency and handling more tasks internally).

* The Company has applied Accounting Standard for Revenue Recognition (ASBJ Statement No. 29; March 31, 2020) since FY3/22, and reported figures following application of the relevant accounting standard in 1H FY3/22 values. Furthermore, updated figures for 1H FY3/21 reflect the change in presentation method and YoY comparisons are shown.

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Summary

3. FY3/22 forecasts

The Company retained the initial outlook for FY3/22 results to deliver higher sales and profits with ¥26,000mn in net sales (+11.4% YoY) and ¥850mn in operating income (+40.0%). It expects a healthy trend in operation of gaming machines again in 2H with pachinko machines as the main driver. Considering the approaching deadline for replacing machines complying with the former regulations at the end of January 2022, the Company expects incremental replacement with machines that meet the new regulations to contribute to an upswing in the gaming machine market. It retained initial forecasts, despite hefty upside versus the plan for various profit items in 1H resulting from a cautious view of the impact of semiconductor shortages (component procurement risk).

4. Disclosure of a new medium-term management plan

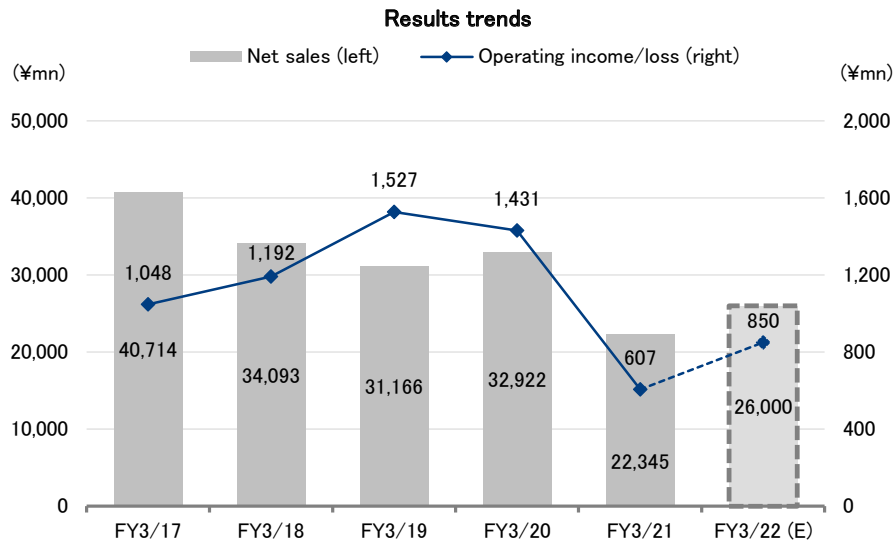
The Company disclosed a new medium-term management plan (three years) starting from FY3/23. While disclosure had been delayed for some time due to persisting uncertain conditions, factors supporting the decision to move ahead with disclosure were full transition to machines that meet the new regulations from February 2022 and seeing a path to livelier conditions in the gaming machine market and pachinko hall capital investments as the new era of smart gaming machines* emerges. Specifically, the Company outlined a strategy of capturing demand related to inroads using smart gaming machines, continued promotion of AI hall computer X (Kai) uptake, and carrying on building the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services). Numerical goals for FY3/25, the final fiscal year, are ¥34,000mn in net sales (+9.4% average growth rate over three years) and ¥2,200mn in operating income (6.5% operating income margin). Projected incremental improvement in the operating income margin relies on recurring business led by MG Services becoming the growth driver and substantial contributions from the resulting change in the earnings structure (lifting the bottom line).

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

Key Points

- Posted higher sales and significantly stronger profits in 1H FY3/22. Growth in mainstay products, recovery in MG Services, and an improved income structure contributed to profit increases exceeding the plan despite ongoing difficult conditions
- Retained initial forecasts for net sales and profit increases in FY3/22. However, these levels conservatively factor in impact from semiconductor shortages
- Disclosed the new medium-term management plan that begins in FY3/23. Aims to build the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services) for the arrival of a new era with smart gaming machines

Summary



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

Description of businesses

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

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

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

The Company's share of the hall computer market is 36.6%, and in particular, its market share of large-scale halls with at least 501 machines is 59.2%.

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

Description of businesses

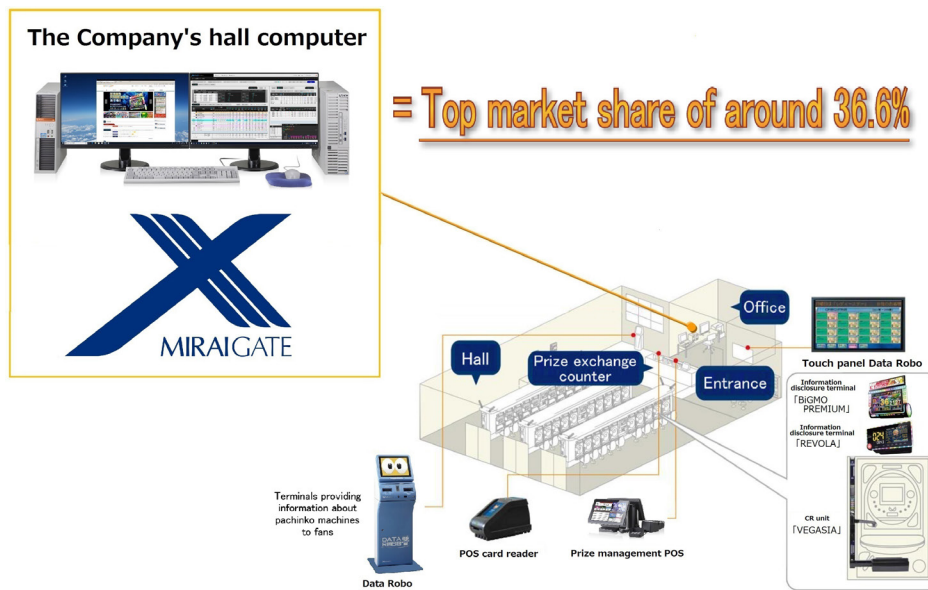
1. Information System Segment

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

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

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

Hall computers and main peripheral equipment



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

Description of businesses

2. Control System Segment

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

■ Company strengths

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

1. Growth model based on market expansion through innovation

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

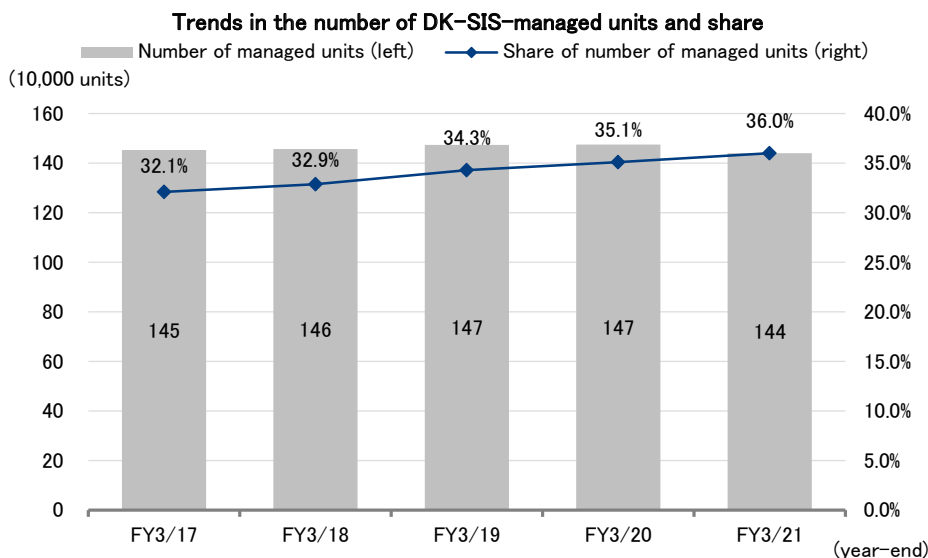
Launched in 1974, the Company's first hall computer enabled managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic data, but with the introduction of hall computers, data-based hall management became the de facto standard.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

In June 2019, the Company released the industry's first AI hall computer, X (Kai). This AI hall computer will not only greatly help the performance of pachinko hall operations suffering from labor shortages, but also improve operating efficiency and reduce necessary labor by having AI automatically analyze big data that the Company possesses by having AI automatically analyze big data that the Company possesses to improve operating efficiency and reduce necessary labor.

Company strengths

2. Strong network of pachinko halls

Another advantage is the 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 and pachislot machines. Simulations based on nationwide gaming machine sales data support forecast management, and a strong network of members underpins the Company's business foundation. Additionally, it occupies an industry think-tank role, contributing to improving the Company's brand power as a leading company, and is utilized in strategic proposals and sales activities to game machine manufacturers. Membership totaled 3,337 halls at the end of March 2021 with 1.44mn managed machines (36.0% share in managed machines). Also, recently it has been focusing on spreading the use of Market-SIS, which is a trading area analysis service that analyzes from various angles factors such as customer numbers, operating rates, occupancy rates, and support rates of competitive halls managed within trading areas. It is being highly evaluated as a tool to ascertain the flow of people (player trends) and that contributes to improving halls' ability to attract customers.

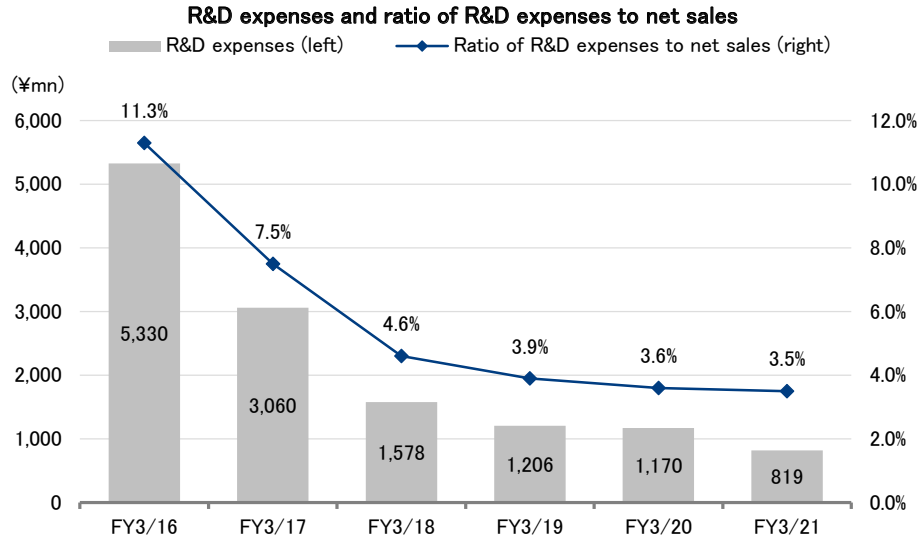


Source: Prepared by FISCO from the Company's materials

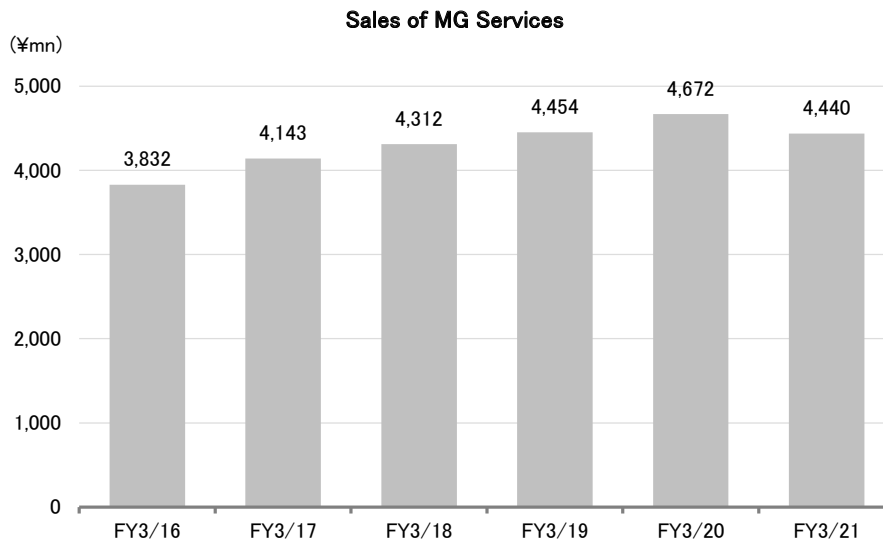
3. Stable profit base that supports investment for the future

The Company's main source of competitiveness is its proactive upfront investment eyeing future growth, including its R&D expenses. Development of a next-generation hall computer (and peripheral equipment) and start of a new MG Services in recent years are evidence of continued aggressive investment in areas expected to become its growth driver. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, MG Services promoted by the Company as a recurring-revenue business model have grown and enabled funding of R&D at a high level while maintaining stable segment income, and investment risk has been limited. The Company's ability to balance large profits from its existing businesses with heavy investment in businesses for future growth allows it to produce value on a continuing basis. While exhaustion of large-scale investments in the next-generation hall computer and other outlays have kept R&D expenses at roughly 4% of net sales since FY3/18, the Company intends to aggressively allocate R&D expenses, mainly for central components of its strategy such as the cloud and smart pachislot, in the new medium-term management plan that begins in FY3/23.

Company strengths



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



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

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■ Industry environment

The gaming machine market is showing signs of an upswing led by the replacement of pachinko machines complying with the former regulations with machines that meet the new regulations ahead of the deadline at the end of January 2022. Semiconductor shortages, meanwhile, are a concern

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

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

However, incremental replacement with machines that meet the new regulations is steadily advancing ahead of the deadline at the end of January 2022. Multiple hit models emerged in the pachinko gaming machine segment, following revisions to the Technology Format Interpretation Standards adopted in January 2020 and releases of gaming machines with new amusement features (such as "play time"*) in accordance with related internal stipulations by Nikkoso, and this activity is stimulating the market with new replacement demand for gaming machines. Replacement progress (switching to machines that meet the new regulations) reached 80% for pachinko gaming machines but was still only at 58% for pachislot gaming machines at the end of September 2021 (Company estimates). The industry is closely watching these trends. The Company plans to newly deploy smart gaming machines in 1H FY3/23 after the full transition to machines that meet the new regulations, and foresees the arrival of a new era in the gaming machine market and pachinko hall industry. Near-term risks, meanwhile, are renewed expansion of the COVID-19 pandemic and delivery delays due to semiconductor shortages.

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

Industry environment

According to surveys by the National Police Agency, the number of pachinko halls in Japan declined at an average annual rate of 3.6% from 2012 to 2020. In particular, there is a noticeable decline in new hall openings due to the impact of the new regulations and other factors. At the end of December 2020, the number of halls was 9,035 (-604 YoY), and the Company served 36.6% of these halls. Its customer halls are often high-end, large pachinko halls that are the top performers in their respective local markets and exceed the market average in size*. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. As the Company moves toward a new era with new smart gaming machines, we expect an excellent opportunity for it to expand business once investment appetites recover, mainly at large halls.

*The Company's share of the large-scale halls (at least 501 machines) market is even higher at 59.2%.

Market scale, the number of halls, and the Company's share of the hall computer market

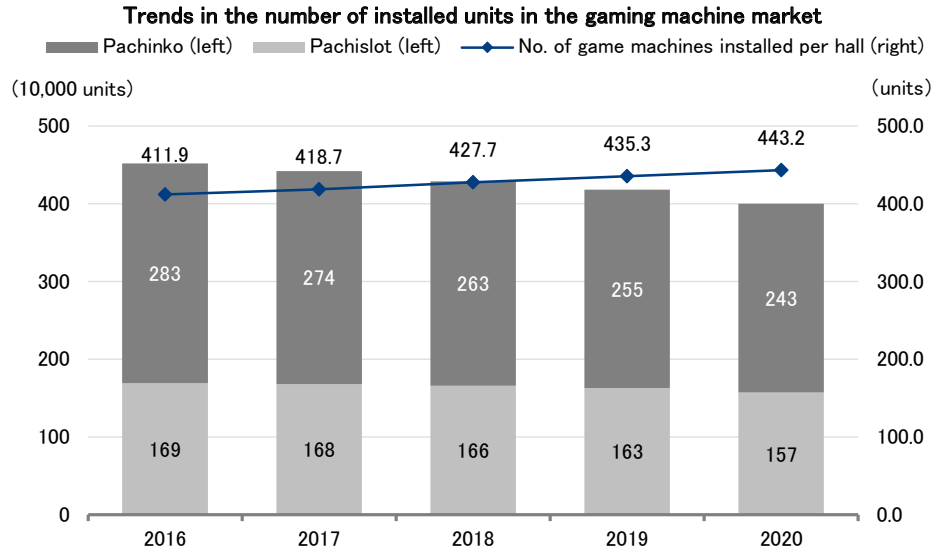


※Market scale (total gross profit) is the value estimated from DK-SIS actual data.
 ※The number of halls is from data in the National Police Agency's Current Status of Entertainment and Amusement Businesses, etc., and the Status of Measures for Crimes relating to Entertainment and Amusement Businesses, etc.

Source: The Company's results briefing materials

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

Industry environment



Source: Prepared by FISCO from Company materials and the Current Status of Entertainment and Amusement Businesses, etc. and the Status of Measures for Crimes relating to Entertainment and Amusement Businesses, etc. 2020 by the Public Security Division of the Security Bureau and the National Police Agency

Financial results trends

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

1. Performance over the past fiscal years

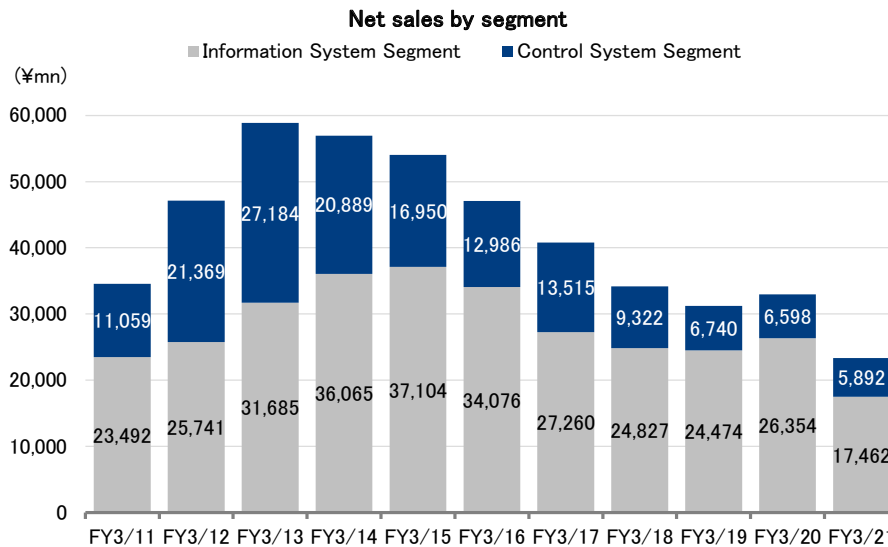
Looking back at past results, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake in FY3/11. Its results rebounded afterwards, even though the pachinko industry continued to contract. This recovery was mainly led by the Information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

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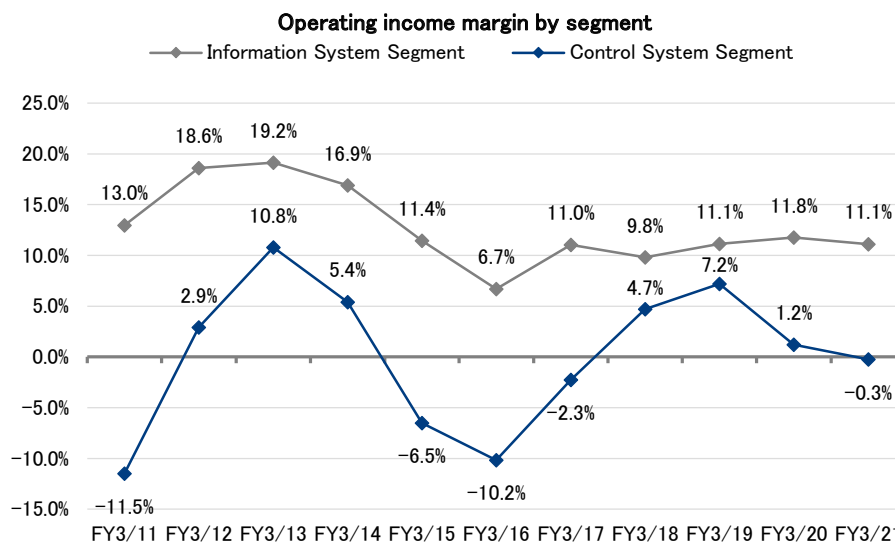
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Financial results trends



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

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



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

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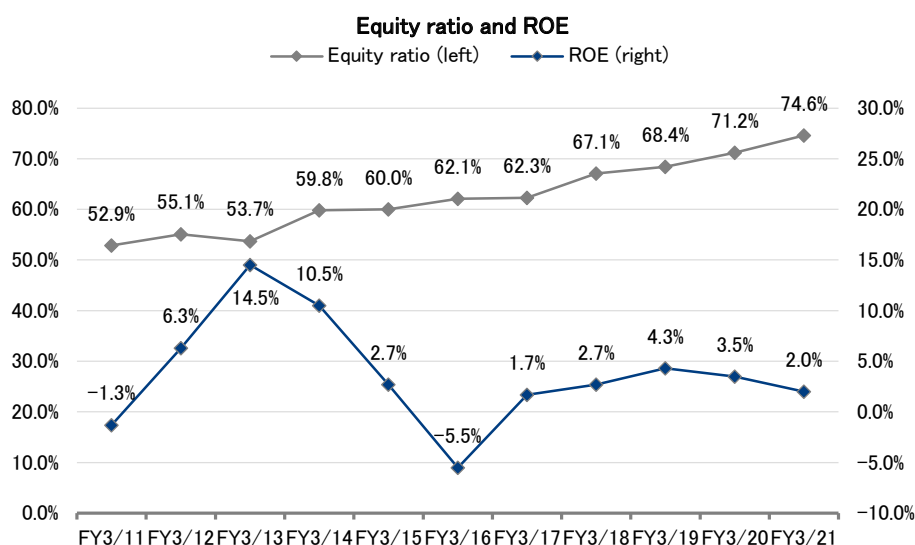
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Financial results trends

In terms of financial indicators, the Company's equity ratio, a measure of financial stability, has been rising, reflecting an accumulation of retained earnings and reaching a high level of 74.6% in FY3/21. The current ratio, which indicates the ability to make payments in the short term, was 267.1%, mainly due to large holdings of cash and deposits, as the Company's robust financial base is a strength not only for business continuity, but also as a source for powering future growth. ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. The Company suffered losses in FY3/15 due to the bankruptcy of a manufacturer customer and in FY3/16 due to the devaluation of parts and materials for its pachislot machines as industry restrictions were placed on risky machines.



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

Posted higher sales and significantly stronger profits in 1H FY3/22. Growth in mainstay products, recovery in MG Services, and an improved income structure contributed amid ongoing difficult conditions

2. Overview of 1H FY3/22 results

The Company posted 1H FY3/22 results with higher sales and significantly stronger profits, including ¥12,047mn in net sales (+8.5% YoY), ¥863mn in operating income (¥185mn loss in the previous period), ¥919mn in ordinary income (¥18mn loss in the previous period), and ¥678mn in net income attributable to owners of the parent (¥48mn loss in the previous period). It restored profits after the previous fiscal year temporarily incurred losses due to the impact of the COVID-19 pandemic. Even compared to the initial outlook, while net sales were roughly on track with the plan, earnings substantially outpaced targets.

Pachinko halls have been refraining from new openings and other large-scale capital investments. Nevertheless, upbeat operation of pachinko machines that meet the new regulations and healthy sales of mainstay REVOLA and VEGASIA products in the Information System Segment contributed considerably to higher sales. The Control System Segment, however, incurred a slight decline in sales due to sluggish sales in parts and others, despite healthy activity in mainstay display and control units.

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Financial results trends

In earnings too, the Company realized a steep increase in operating income thanks to the profit boost from higher sales and cost reductions, and the operating income margin exceeded the pre-pandemic level (7.0% in 1H FY3/20) at 7.2%. Main sources of large upside versus the initial outlook were growth in mainstay products with high profitability, recovery in MG Services that generate recurring revenue, and success in initiatives to lower companywide costs (such as work improvements like workstyle reforms and promotion of increased efficiency and handling more tasks internally). R&D expenses dropped 41.0% YoY to ¥251mn, though the Company intends to aggressively allocate funds in 2H targeting growth from FY3/23.

Looking at fiscal conditions, total assets declined 5.3% from the end of FY3/21 to ¥38,917mn due to a drop in merchandise and products related to revisions of the procurement plan, postponement of the plan for purchasing fixed assets, and recognition of depreciation costs. Shareholders' equity, meanwhile, only rose slightly with a 1.0% increase to ¥30,964mn as roughly equal amounts were allocated for year-end dividend payments and retained earnings, and the capital ratio climbed to 79.6% (74.6% at the end of FY3/21). The Company has a sound fiscal position with ¥15,426mn in cash and deposits and a current ratio of 342.1%.

Overview of 1H FY3/22

	1H FY3/21		1H FY3/22		Change		(¥mn)			
	Results	Share	Results	Share	% change	1H FY3/22		Updated outlook	Share	
						Initial forecast	Share			
Net sales	11,099		12,047		948	8.5%	12,000		12,000	
Information System Segment	8,206	73.9%	9,187	76.3%	981	12.0%	9,000	75.0%	-	-
Control System Segment	2,897	26.1%	2,866	23.8%	-30	-1.1%	3,000	25.0%	-	-
Adjustment	-4	-	-6	-	-2	-	-	-	-	-
Gross profit	4,370	39.4%	5,103	42.4%	732	16.8%	-	-	-	-
SG&A expenses	4,556	41.1%	4,239	35.2%	-316	-7.0%	-	-	-	-
Operating income (loss)	-185	-1.7%	863	7.2%	1,049	-	200	1.7%	650	5.4%
Information System Segment	540	6.6%	1,346	14.7%	806	149.3%	900	10.0%	-	-
Control System Segment	33	1.1%	265	9.3%	232	702.0%	100	3.3%	-	-
Adjustment	-759	-	-749	-	10	-	-800	-	-	-
Ordinary income (loss)	-18	-0.2%	919	7.6%	937	-	270	2.3%	750	6.3%
Net income (loss) attributable to owners of the parent	-48	-0.4%	678	5.6%	727	-	175	1.5%	450	3.8%
Depreciation	994		867		-127	-12.8%				

	End of FY3/21	End of 1H FY3/22	YoY	
			Change	% change
Total assets	41,084	38,917	-2,167	-5.3%
Total equity	30,662	30,964	301	1.0%
Equity ratio	74.6%	79.6%	5.0pt	-

Notes: The Company has applied Accounting Standard for Revenue Recognition (ASBJ Statement No. 29; March 31, 2020) since FY3/22, and reported figures following application of the relevant accounting standard in 1H FY3/22 values. Furthermore, updated figures for 1H FY3/21 reflect the change in presentation method and YoY comparisons are shown

Revised 1H FY3/22 estimates are those disclosed in August 2021

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

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Financial results trends

The results by segment were as follows.

(1) Information System Segment

The segment reported sharply higher sales and profits with net sales at ¥9,187mn (+12.0% YoY) and segment profit at ¥1,346mn (+149.3%). While strengthening promotion of Market-SIS, a trading area analysis service, and proposals for utilization of the AI hall computer X (Kai) and making efforts to transition customers from existing hall computers to more advanced systems, the Company continues to face conditions in which pachinko halls are refraining from new site openings and other large-scale capital investments amid caution accompanying the prolonged pandemic and priority on replacing machines complying with the former regulations with machines that meet the new regulations. The main factor in successful attainment of higher sales despite a tough environment was upbeat growth in sales of information disclosure terminal REVOLA and CR unit VEGASIA related to an increase in smaller projects involving shifting from pachislot to pachinko at some pachinko halls*1. Sales of “One-Stop Self-Counter,”*2 a POS system that addresses infectious disease and labor-saving measures, were strong too. Segment earnings improved substantially due to growth in mainstay products with high profitability, contributions from raising service sales, recovery in MG Services, a recurring-revenue business, and cost reductions, and the segment margin reached a high level at 14.7%.

*1 With the spread of machines with “play time,” a new game feature, and the emergence of hit models attracting strong support, pachinko machines are performing better than pachislot machines, and the increase in these projects indicates as such. Additionally, replacement progress (switching to machines that meet the new regulations required by the end of January 2022) reached 80% for pachinko gaming machines, an upbeat pace, but lagged at only 58% for pachislot gaming machines at the end of September 2021.

*2 The counter facilitates functions, ranging from prepaid card balance settlement to prize exchange, in one stop without the need for hall staff.

(2) Control System Segment

The segment reported a steep rise in profits on slightly lower sales with net sales at ¥2,866mn (-1.1% YoY) and segment profit at ¥265mn (+702.0%). Although sales of mainstay displays and control units to gaming machine manufacturers increased YoY amid a gradual upswing in the gaming machine market due to robust sales of pachinko machines and the start of consignment manufacturing of pachislot machines as a broadening of business scope, overall sales slightly declined because of a slump in sales of parts and others. Earnings, however, delivered a hefty gain with cost cutbacks achieved by strengthening development management and boosting work efficiency as a result of major reorganization conducted at the beginning of the period and growth in mainstay products with high profitability.

3. Summary of 1H FY3/22

As a summary of the situation in 1H FY3/22 based on these trends, even though pachinko halls have not fully ramped up investment appetites yet, the Company successfully recruited new demand that has been gradually materializing, such as expanded sales of machines with the “play time” feature, and used it to improve income results. This is a positive indicator for the future because it proves that products and services promoted by the Company have effectively tapped into latent demand. Another favorable point is progress in improvement of the Control System Segment’s income capabilities.

■ Main activities

The Company saw some results from holding the online-format MIRAIGATE 2021 Web Exhibition & Seminar and other initiatives for sustainability

1. Held the MIRAIGATE 2021 Web Exhibition & Seminar

Each year, the Company participates in various exhibitions and seminars held nationwide to provide proposals, such as on new products and services that are useful for hall management (data utilization, etc.), and these events are important places for conducting sales and building relations. MIRAIGATE Web Exhibition & Seminars have continued to be held online since 2020 as a pandemic-related measure, and this year's event in September (September 1-14) attracted about 5,500 participants. Participation was likely facilitated by being held online, but even so, within the ongoing severe industry environment, this can be understood as showing great expectations and potential demand for the Company's products and proposals. MIRAIGATE 2021 Web Exhibition & Seminar highlighted the three major themes of "changing data management," "changing customer attraction," and "changing workstyles," and proposed products and services that contribute to those themes. At the SIS Online Seminar held during this time, the Company discussed market analysis utilizing big data and management and sales strategies that improve income based on a "make rapid progress" theme.

2. Initiatives in sustainability

The Company formed a Sustainability Committee in November 2021 for the purpose of promoting sustainability activities in a continuous and organized manner and realizing sustained growth and a sustainable society through management that emphasizes ESG and SDGs. It aims to create medium- to long-term corporate value rooted in the corporate philosophy of "continuing to consistently deliver sustainable growth in the future by creating new value through innovations." The Sustainability Committee is chaired by the Chairman of the Board of Directors (Representative Director) and consists of the President (Representative Director), Senior Managing Director (Representative Director), and Managing Director, and its activities include formulating the sustainability policy, identifying materiality, conducting reviews of sustainability promotion activities, and submitting reports and recommendations to the Board of Directors. Regarding formulating the sustainability policy and identifying materiality, it intends to disclose information by March 2022.

■ Outlook

Retained initial forecasts for net sales and profit increases in FY3/22. Despite the prospect of sustaining healthy momentum in mainstay products, these levels conservatively factor in impact from semiconductor shortages

1. FY3/22 forecast

The Company retained the initial outlook for FY3/22 results to deliver higher sales and profits with ¥26,000mn in net sales (+11.4% YoY), ¥850mn in operating income (+40.0%), ¥1,000mn in ordinary income (+1.3%), and ¥650mn in net income attributable to owners of the parent (+6.1%).

It forecasts a healthy trend in operation of gaming machines again in 2H, with pachinko machines as the main driver. Considering the approaching deadline for replacing machines complying with the former regulations at the end of January 2022, the Company expects incremental replacement with machines that meet the new regulations to contribute to an upswing in the gaming machine market, and the outlook is skewed toward 2H.

It retained initial forecasts, despite hefty upside versus the plan for various profit items in 1H due to a cautious view of the impact of semiconductor shortages (component procurement risk).

FY3/22 forecast

	FY3/21		FY3/22		YoY change	
	Result	Share	Forecast	Share		% change
Net sales	23,345		26,000		2,654	11.4%
Information System Segment	17,462	74.8%	19,500	75.0%	2,037	11.7%
Control System Segment	5,892	25.2%	6,500	25.0%	607	10.3%
Adjustment	-9	-	-	-	-	-
Gross profit	9,504	40.7%	10,400	40.0%	895	
SG&A expenses	8,897	38.1%	9,550	36.7%	652	
Operating income	607	2.6%	850	3.3%	242	40.0%
Information System Segment	1,939	11.1%	1,850	9.5%	-89	-4.6%
Control System Segment	100	1.7%	600	9.2%	499	500.0%
Adjustment	-1,444	-	-1,600	-	-155	-
Ordinary income	986	4.2%	1,000	3.8%	13	1.3%
Net income attributable to owners of the parent	612	2.6%	650	2.5%	37	6.1%

Note: The Company has applied Accounting Standard for Revenue Recognition (ASBJ Statement No. 29; March 31, 2020) since FY3/22, and reported figures following application of the relevant accounting standard in FY3/22 values. Furthermore, YoY comparisons are calculated using figures for the previous year that reflect changes in the presentation method

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

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Outlook

2. Policy for main activities**(1) Information System Segment**

The Company hopes to continue expanding sales of mainstay products, such as the REVOLA information disclosure terminal that communicates information from “play time” machines to fans in an easily understood manner and CR unit VEGASIA, and increase sales of the AI hall computer X (Kai) that supports machines that meet the new regulations, which are steadily replacing existing machines, and bolsters simulation and gaming machine management features. Regarding MG Services, it is promoting inroads by Market-SIS, a trading area analysis service, and pursuing market deployment and uptake of next-generation service ClarisLink*, a cloud-based chain store management system.

* This system supports data sharing among chain stores anytime and anywhere with simple operability and smooth responses. Big data is also uploaded to the cloud-based data server and compared and analyzed, providing a view of the industry and enabling formulation of strategies with a solid foundation. The Company plans to promote the system as the platform discussed in its new medium-term management plan.

(2) Control System Segment

The Company intends to broaden its business scope through sales of proprietary pachislot systems* and pursue improved quality and enhanced profitability from software development consignment projects by raising business efficiency.

* With the aim of effectively utilizing (OEM) molds, etc. owned by the Company.

3. FISCO's opinion

To attain FY3/22 targets, the Company needs at least ¥13,953mn in net sales, though it could book up to a ¥13mn loss in operating income, in 2H. Despite plans to increase R&D expenses and capital investments in 2H with the aim of achieving growth from FY3/23 (realizing goals in the new medium-term management plan), FISCO thinks it is reasonable to expect upside in earnings as a result of this clearly low hurdle. The outlook is not totally optimistic, however, as the Company has cited the risk of semiconductor shortages becoming a serious bottleneck in business activities. Nevertheless, even if this risk weakens earnings, it is important to recognize it is a one-time supply issue and does not involve any setbacks in demand that would affect growth potential or undermine competitiveness. FISCO intends to focus on growth in mainstay products accompanying replacement with machines that meet the new regulations and full-fledged capital investment activity by pachinko halls after completing the transition.

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■ Medium-term management plan

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

The Company disclosed a new medium-term management plan (three years) starting from FY3/23 on November 24, 2021. While disclosure had been delayed for some time due to persisting uncertain conditions related to the pace of the transition from machines complying with the former regulations to machines that meet the new regulations and accompanying changes in the industry environment and capital investment trends, factors supporting the decision to move ahead with disclosure, meanwhile, were full transition to machines that meet the new regulations with a deadline of the end of January 2022 and seeing a path to livelier conditions in the gaming machine market and pachinko hall capital investments as the new era of smart gaming machines emerges. Based on the corporate philosophy of “continuing to consistently deliver sustainable growth in the future by creating new value through innovations,” the Company intends to redefine business domains as a way of addressing future changes in the market environment. Specifically, it outlined a strategy of capturing demand related to inroads using smart gaming machines that are slated for new release, continuing promotion of AI hall computer X (Kai) uptake, and carrying on building the industry's only platform through rollout of business utilizing a cloud server (reinforcement of new MG Services).

1. Market environment

The gaming machine market and pachinko hall industry are anticipating the arrival of a new era led by smart gaming machines accompanying full transition to machines that meet the new regulations from February 2022 and new rollout of smart gaming machines planned in 1H FY3/23. The switch to smart gaming machines might dramatically advance data collection and utilization and significantly affect fan growth and the format of hall management by broadening “game” aspects. In particular, some observers think manifestation of differences in customer draw by individual pachinko halls might accelerate the trend of industry reorganization being driven by leading companies. The Company envisions a scenario of significant income expansion from the second year of the medium-term management plan (FY3/24) amid advances in the shift to smart gaming machines as pachinko halls ramp up capital investments (including new site openings) for survival.

2. Priority measures (redefining business domains)

(1) Information System Segment

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

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

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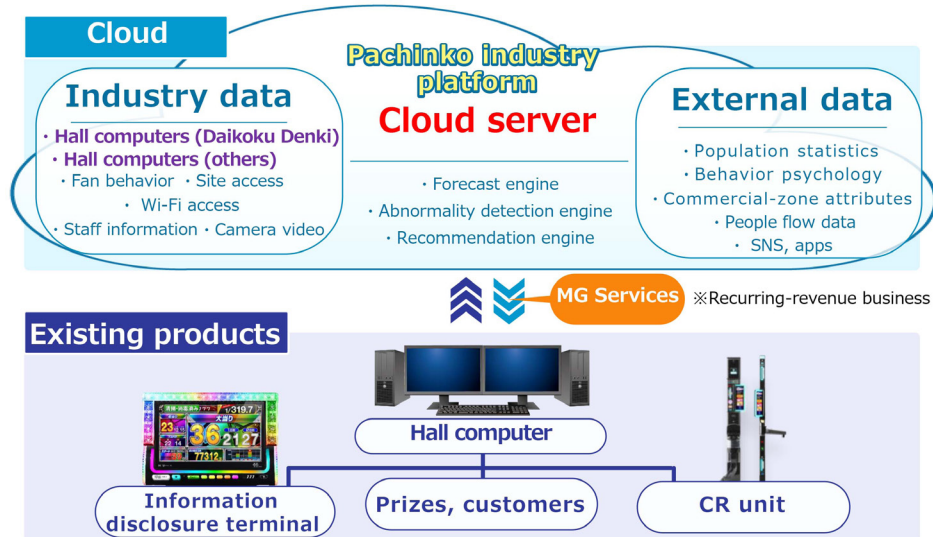
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Medium-term management plan

Target image after three years



Source: The Company's results briefing materials

(2) Control System Segment

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

3. Investment plan

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

4. Numerical goals

Numerical goals for FY3/25, the final fiscal year, are ¥34,000mn in net sales (+9.4% average growth rate over three years) and ¥2,200mn in operating income (6.5% operating income margin). While the Company anticipates results in FY3/23 to be on par with FY3/22 forecasts, reflecting the difficulty of assessing the timing of full-fledged profit gains (ramp-up of capital investments at pachinko halls) due to semiconductor shortages and the impact of the COVID-19 pandemic, it factors in realization of significant business expansion in the second year (FY3/24). Additionally, projected incremental improvement in the operating income margin, despite aggressive R&D spending and capital investments, relies on enhanced added value in various product areas, recurring business led by MG Services becoming the growth driver and substantial contributions from the resulting change in the earnings structure (lifting the bottom line).

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Medium-term management plan

New medium-term management plan

(¥mn)

	FY3/22		FY3/23 (First year of the medium-term management plan)		FY3/24 (Second year of the medium-term management plan)		FY3/25 (Third year of the medium-term management plan)		Average growth rate (Three years)
	Forecast	Share	Target	Share	Target	Share	Target	Share	
Net sales	26,000		26,000		32,000		34,000		9.4%
Information System Segment	19,500	75.0%	19,500	75.0%	25,000	78.1%	26,500	77.9%	10.8%
Control System Segment	6,500	25.0%	6,500	25.0%	7,000	21.9%	7,500	22.1%	4.9%
Gross profit	10,400	40.0%	10,400	40.0%	11,970	37.4%	13,100	38.5%	8.0%
SG&A expenses	9,550	36.7%	9,550	36.7%	10,270	32.1%	10,900	32.1%	4.5%
Operating income (loss)	850	3.3%	850	3.3%	1,700	5.3%	2,200	6.5%	37.3%
Ordinary income (loss)	1,000	3.8%	950	3.7%	1,800	5.6%	2,300	6.8%	32.0%
Net income (loss) attributable to owners of the parent	650	2.5%	650	2.5%	1,200	3.8%	1,500	4.4%	32.1%

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

5. FISCO's focus

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

Shareholder returns

Planning a steep dividend hike in FY3/22. Resuming the shareholder benefit program too

Regarding the dividend, the Company has a fundamental policy of paying a stable dividend and implements a special dividend based on earnings. In FY3/22, it plans to pay a ¥55 dividend per share for the full year (¥25 interim, ¥30 year-end), an increase of ¥15 YoY. There is also room to raise the dividend further depending on future profit growth.

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

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



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■ For inquiry, please contact: ■

FISCO Ltd.

5-13-3 Minami Aoyama, Minato-ku, Tokyo, Japan 107-0062

Phone: 03-5774-2443 (IR Consulting Business Division)

Email: support@fisco.co.jp