

Digital Arts Inc.

2326

Tokyo Stock Exchange First Section

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FISCO Ltd.

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

■ Index

■ Summary	01
■ Company overview	03
1. Company overview	03
2. History	03
■ Business overview	05
1. Web security products (web security software)	06
2. Email security products (email security software)	07
3. File security products (file encryption and tracking solutions)	07
■ Strengths and business risks	08
1. Strengths	08
2. Business risks	08
■ Performance trends	09
1. Past results	09
2. Review of FY3/19 results	10
3. Trends by market segment	11
4. Financial status and management indicators	13
■ Outlook	14
1. Outlook for FY3/20	14
2. Market environment and priority initiatives	15
■ Medium- to long-term management strategy	16
■ Shareholder return policy	17
■ Information Security	17

Summary

Top market share for Web security software, is on track for a new growth stage

Digital Arts <2326> is an information security manufacturer involved in the planning, development, and sales of Internet security-related software, focusing on Web security*, email security, and file security. It conducts the entire process, from product planning and development through to sales and support in-house, and it has put in place a system in which it can promptly respond to the needs of businesses and individual users including quick provision of support, software version upgrades, and web security databases. It has been highly evaluated for having the largest domestic web security database, which supports the foundations of its security products, and its technological capabilities for which it has acquired patent approval in 27 countries and regions around the world, and has the No.1 market share in Japan for Web security software.

* Security software is software with functions to separate websites on the Internet into those that can be viewed and those that cannot be viewed according to the settings of the user. In contrast to anti-virus software, which protects PCs, smartphones, and other devices from the risk of being invaded by a virus, security software is said to protect people, in that it prevents users from being exposed unintentionally to dangers on the Internet.

In the FY3/19 consolidated results, net sales increased 14.2% YoY to ¥5,841mn, operating profit rose 38.2% to ¥2,629mn, recurring profit climbed 37.8% to ¥2,630mn, and net profit attributable to owners of parent grew 53.0% to ¥1,961mn, and both sales and profits were new record highs. The Company has been highly evaluated for its track record and the reliability it has accumulated as a manufacturer of security software to prevent leaks regarding internal information and sales progressed of i-FILTER Ver.10 and m-FILTER Ver.5, which make advanced security measures, including against targeted attacks possible, and they contributed to the growth of results.

The Company is also forecasting higher sales and profits for FY3/20, with net sales to increase 16.4% YoY to ¥6,800mn, operating profit to rise 25.5% to ¥3,300mn, recurring profit to grow 25.4% to ¥3,300mn, and net profit attributable to owners of parent to climb 16.1% to ¥2,277mn. In contrast to license-sales products, for which the license-fee amount is recorded as sales collectively at the time of shipment, sales for cloud services-based products are recorded on a monthly basis throughout the contract period. Therefore, the percentage of total net sales provided by cloud services-based products trended upward in the previous fiscal period, and this trend is forecast to further accelerate in FY3/20, and it seems that the Company formulated the initial budget expecting conservative financial adjustments.

At FISCO, we think that the Company's forecasts are conservative with room for results to exceed them in light of 1) the Company tends to sets conservative values for its initial forecasts numbers, 2) the sales conditions of the mainstay products, i-FILTER Ver.10 and m-FILTER Ver.5, continue to be steady, 3) the percentage of sales from cloud-based services rose and sales were slightly sluggish in the private sector and public-sector markets, in the previous fiscal period, but this has already been incorporated into the FY3/20 forecasts; 4) it is enhancing its product lineup, including new functions to FinalCode, and is acquiring momentum to grow sales through cross sales to companies that have not yet introduced all of its services.

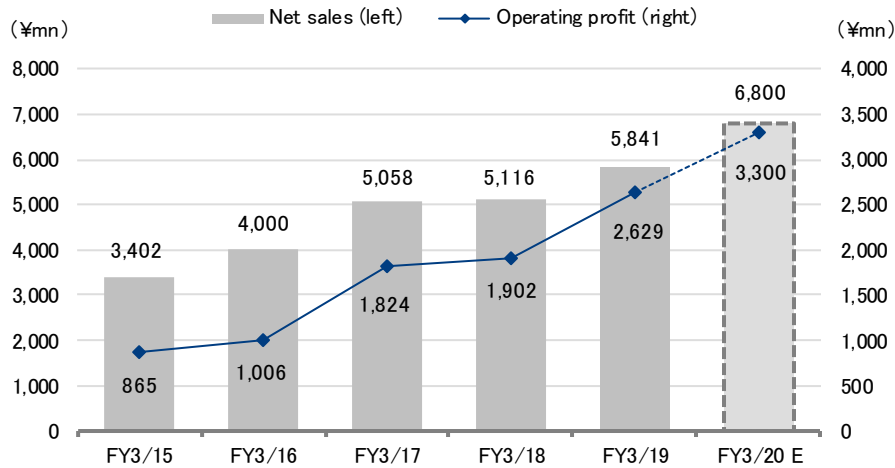
Summary

For returns to shareholders, the Company’s basic policy is to stably and continuously pay dividends while retaining the internal reserves necessary to secure the funds to further strengthen its management foundation and to prepare for the spread of web security, e-mail security, and other information security software, on an outlook for rapid market expansion. Therefore, it targets a dividend payout ratio of approximately 30% of consolidated net profit. The FY3/19 dividend was ¥48 (34.0% dividend payout ratio), and it is forecasting a dividend of ¥50 (¥25 interim dividend) for a dividend payout ratio of 30.5% for FY3/20.

Key Points

- In the FY3/19 results, both sales and profits were new record highs
- Sales of i-FILTER Ver.10 and m-FILTER Ver.5 (to protect against external targeted attacks) are steadily growing
- In the public-sector market, its presence as a manufacturer of comprehensive security measures has increased

Result trends



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

■ Company overview

In the web security market, has the No.1 share among security software manufacturers

1. Company overview

The Company is a security software manufacturer that conduct the planning, development, and sales of Internet security software and appliance products for the private sector (companies), the public-sector (government ministries and agencies, and schools) and the home-use markets. Since its establishment, it has created and supplied information security solutions, such as web security and email security, which prevent dangers related to Internet access, and file encryption and tracking solutions, which protect important information contained in files, based on its corporate policy of “contributing to a more convenient, more comfortable, and safer Internet life.” It conducts the entire process, from product planning and development through to sales and support in-house, and it has established operations in which it can promptly address the needs of users, including quick provision of support, software version updates, and a web security database. It is currently developing security products for the Internet, e-mail, and files as its core business. The Company has been highly evaluated for providing the largest web security database in Japan, which supports the foundations of its security products, and its technological capabilities, for which it has acquired patents in 27 countries and regions, and it has acquired a market share of more than 50% for Internet security software in Japan.

2. History

Representative Director Toshio Dogu* founded Digital Arts in June 1995 with the primary aim of developing and selling Internet-related application software. In its initial years, the Company developed and sold Internet software tools, but in August 1998 it developed Japan’s first web security software, and at the same time it started collecting information on potentially harmful sites. It released the Internet security software i-FILTER School Edition for schools in July 2000 and the i-FILTER Business Edition for companies in January 2001. It steadily expanded its business by adding features to these products and expanding its product line-up. The Company was listed on the Osaka Stock Exchange NASDAQ Japan market (currently, Tokyo Stock Exchange (TSE) JASDAQ (Growth)) in September 2002, the 7th year after its establishment. (Its listing was subsequently moved to TSE-2 in February 2012 and TSE-1 in March 2013).

* He joined Shin Nihon Kohan Corporation (currently, Forval Corporation <8275>) in 1988 and held a sales position. He then worked in programming at MacroSystem Co., and handled business planning for education and entertainment at TDK Core Ltd., (currently, Nippon Columbia 6791). He was appointed Representative Director and President of Digital Arts in October 1997.

The Company began the NET iScope Internet monitoring service* as a corporate risk management tool in May 2000, and this business subsequently steadily expanded. However, it decided that it lacked sufficient resources to further expand both this business and its mainstay security business, so it sold the NET iScope business to Gala <4777> in September 2004, and concentrated its resources into the security software field.

* This service provides continuous information monitoring from Internet-based entries and other sources. It searches domestic websites using key words specified by customers as the search criteria and gives customers URLs that contain information that meets these search criteria.

Digital Arts Inc. | 2-Aug.-2019
 2326 Tokyo Stock Exchange First Section | <https://www.daj.jp/en/>

Company overview

Subsequently, in February 2007, it launched sales of the m-FILTER e-mail security software and further expanded the business scale. It began sales of D-SPA, a secure proxy appliance, in November 2010, and then starting providing FinalCode in June 2010, establishing its current product lineup.

In May 2013, the Company entered-into a business alliance with US-based Polkast LLC* and established Polkast Japan in order to expand services in Japan. But it concluded that it would be difficult to provide services with high levels of customer satisfaction and dissolved this business alliance and liquidated Polkast Japan in July 2015.

* This service lets companies and households create a cloud using their own PC and supports the management of document files, video, music, and photo files, and other electronic data, and it also enables access control and data transfers among multiple devices, including smartphones and tablets, in a high-speed and secure environment, using the Polkast application for building original clouds in the global market.

Meanwhile, the Company founded FinalCode, Inc., in the US in April 2014 with the goals of promoting a new concept of security measures worldwide and expanding sales of FinalCode in North America. It established Digital Arts Asia Pacific Pte., Ltd., in Singapore in November 2015 and renamed it FinalCode Asia Pacific Pte., Ltd., in February 2016. It also renamed UK-based Digital Arts Europe Ltd., (founded in April 2011) as FinalCode Europe Limited, and it is working to establish overseas bases for sales of FinalCode. Furthermore, it founded Digital Arts Consulting Inc., in April 2016 to focus on a management strategy and IT strategy consulting business and help recruit major corporate customers in Japan. Most recently, it has organizational restructuring through reviewing the overseas strategy, and the names of its regional sale subsidiaries in the United States, the United Kingdom, and Asia have been changed to Digital Arts America, Inc., Digital Arts Europe Limited, and Digital Arts Asia Pacific Pte. Ltd., respectively.

History

Date	History
June 1995	Founded Digital Arts in Tokyo (Minato-ku) with ¥10mn in capital in June 1995 with the primary aim of developing and selling Internet-related application software
August 1998	Developed Japan's first web filtering software and started collecting information on problematic sites
May 2000	Began NET iScope Internet monitoring service
September 2002	Listed shares on the Osaka Stock Exchange NASDAQ Japan market (now, Tokyo Stock Exchange JASDAQ (Growth) market)
September 2004	Sold the NET iScope Internet monitoring service business and shifted to concentrating resources in filtering software.
February 2005	Gained approval for a "patent on Internet access control including filtering" in 22 countries (it had rights for this patent in 27 countries as of 31 March, 2015)
March 2005	Acquired all shares in IQS' Co., Ltd. (now a consolidated subsidiary)
December 2010	Moved its share listing to Osaka Stock Exchange JASDAQ (Standard) (now, Tokyo Stock Exchange JASDAQ (Standard))
April 2011	Established Digital Arts America, Inc. as a US subsidiary
April 2011	Established Digital Arts Europe Ltd. as a UK subsidiary (renamed as FinalCode Europe Limited in February 2016)
February 2012	Listed shares on the Tokyo Stock Exchange Second Section
May 2012	Delisted shares from Osaka Stock Exchange JASDAQ (Standard) (now, Tokyo Stock Exchange JASDAQ (Standard))
June 2012	Established Digital Arts Investment, Inc. as a US subsidiary
March 2013	Change its share listing to the Tokyo Stock Exchange First Section
May 2013	Established Polkast Japan and formed a business alliance with US-based Polkast LLC
June 2013	Formed a strategic business alliance and conducted a business transfer with NRI Secure Technologies, Ltd.
April 2014	Established FinalCode, Inc. as a US subsidiary
January 2015	Ended the business alliance with US-based Polkast LLC
July 2015	Liquidated Polkast Japan
November 2015	Established Digital Arts Asia Pacific Pte., Ltd. in Singapore in November 2015 and renamed it FinalCode Asia Pacific Pte., Ltd. in February 2016
April 2016	Established Digital Arts Consulting Inc.

Source: Prepared by FISCO from the Company's securities report and website

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Business overview

Mainly supplies security products for the web, e-mail, and files

As of the end of March 2019, the Digital Arts Group was comprised of a total of six companies, the Company itself and its five subsidiaries. Of these, four are consolidated subsidiaries (as of the end of March 2019), including Digital Arts Asia Pacific Pte., Ltd., Digital Arts Europe Limited., Digital Arts America, Inc., and Digital Arts Consulting. As an important subsidiary other than the above four, Digital Arts Investment, Inc., was established in the United States in June 2012.

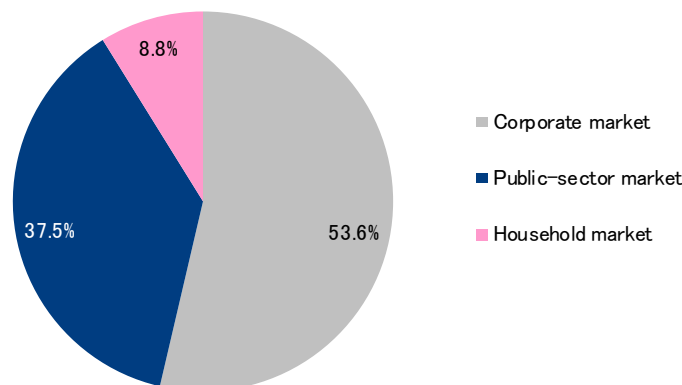
Positioning of Digital Arts and consolidated subsidiary businesses

Company	Main business content	Consolidated
Digital Arts	Plans, develops, and sells Internet security software and appliance products	-
Digital Arts Asia Pacific Pte. Ltd.	Sells Internet security software and appliance products in Asia	○
Digital Arts Europe Limited	Sells Internet security software and appliance products in Europe	○
Digital Arts Consulting Inc.	Operates management strategy and IT strategy consulting businesses.	○
Digital Arts America, Inc.	Sales of Internet security software and appliance products in North America	○
Digital Arts Investment, Inc.	Investment business in North America	-

Note : A circle in the consolidated column indicates a consolidated subsidiary as of end of March 2019
 Source: Prepared by FISCO from the Company's securities report and press release

The Company's business is mainly the provision of security services for general corporations, government agencies, and individuals, which involves the planning, development, and sales of web security software, email security software, and file encryption and tracking solutions. It only discloses information about the security business segment, but it discloses information about the status of each user market. The percentages of total net sales by market for FY3/19 was 53.6% from the corporate, 37.5% from the public-sector, and 8.8% from household.

Sales ratios by market (FY3/19)



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

Business overview

The products that the Company develops and sells are classified into three categories; (1) web security products, (2) email security products, and (3) file security product. The sales methods are direct sales (via applications on the Company's websites) and sales via sales agents and retailers. But for the corporate and the public-sector customers, the majority of sales are handled by major sales agents, including SB C&S Co., Ltd. (subsidiary of SB C&S Holdings) and Daiwabo Information System Co., Ltd. (subsidiary of Daiwabo Holdings Co., Ltd. <3107>).

1. Web security products (web security software)

Security software is software with functions to separate websites on the Internet into those that can be viewed and cannot be viewed according to the user settings. The main products are i-FILTER, i-FILTER Browser & Cloud, and D-SPA for the corporate and public-sectors, and i-Filter for household consumers.

For the mainstay license-sales products (on premise versions), the business model provides stable recurring revenue because software customers pay software usage fees (software license and maintenance fees) in the first fiscal year of installing the software, and then pay half of the amount paid in the first fiscal year each year from the second year onwards. The Company records software development costs, with a portion that goes under expenses and a portion recorded in assets and subsequently amortized. Its profit is the difference between these amounts and sales.

The respective features of the Company's main products are described below (Based on the latest versions as of April 2019).

(1) i-FILTER Ver.10

The i-FILTER Ver.10, which is the latest web security software product, links with the m-FILTER Ver.5 email security software to realize the ultimate security to prevent both external attacks and internal leaks. It achieves complete security in a single product, from protection from targeted attacks* through to web security, and its features include the flexible control of web services and risk management through "visualization."

* Targeted attacks refer to cyber-attacks against a specific organization or individual with a clear purpose, such as to acquiring information or money fraudulently, or obstructing business.

(2) i-FILTER Browser &Cloud

This is web security software for smart devices that curtails private usage and prevents information leaks by supporting the centralized control of multiple operating systems, ranging from smart devices equipped with Android and iOS (iPhone, iPad, and others) to notebook PCs and other Windows terminals.

(3) i-Filter for Consumers

Digital Arts supplies home-use products under the i-FILTER for Consumers brand. Key products are "i-FILTER for multi-devices" service that runs on all Windows, iOS, and Android devices, and PC service, game console service, and smartphone, tablet, and music player service. This series supports a wide range of devices.

Products are installed as a standard feature on the smartphones of the major carriers, and they are officially adopted by Internet service providers; major game consoles, including Nintendo's <7974> 3DS and Wii, and Sony's <6758> PlayStation and PSP; and TV and mobile terminal services.

Business overview

2. Email security products (email security software)

This software is capable of controlling email transmission and reception based on user settings. Main products are m-FILTER and m-FILTER MailAdviser. Digital Arts has installed products at more than 3,000 organizations, including companies and public ministries and agencies (as of September 2016). Same as i-FILTER, for the mainstay license-sales product (on premise version), users of m-FILTER pay a software licensing fee in the first fiscal year and then pay maintenance fees from the second year onwards.

(1) m-FILTER (Ver.5)

This product realizes diverse and reliable measures to prevent mistaken mail transmission, such as holding transmissions going out of a company for a certain amount of time and blocking transmissions that lack approval from a superior. The latest version, Ver.5, links with i-FILTER Ver.10 to realize measures to protect against external targeted attacks by email and prevent internal leaks.

(2) m-FILTER MailAdviser

This is a client-type software that prevents mistaken mail transmission by giving on-the-spot “notices” to email senders.

3. File security products (file encryption and tracking solutions)

This is a password-less encryption services that can track and remotely control electronic files. The main product is FinalCode, and its latest version, Ver.6, was released in June 2019. Following the version upgrade, the Company also significantly renewed the price and license system. It newly established a price system according to the number of licenses purchases, and the content of this system is to provide volume discounts for customers with large contracts. To give an example of an annual license fee, if 1 company purchases 10 licenses, the standard price is ¥120,000 (10 users x ¥12,000). Within this price, 10 employees who are registered as users can execute file encryption and editing, and if only browsing, a total of up to 100 people, of 90 people in addition to the 10 users, can use it free of charge.

Its key features are 1) a file encryption and tracking solution service that encrypts important files, tracks usage, and facilitates remote deletion (file encryption software), 2) the elimination of the risk of indirect information leaks to a third party through a transfer (secondary leak) because of file encryption for a specified user group, and 3) the ability to easily recover (eliminate) important encrypted files, which had been impossible to do in the past, through the active revision of rights after distribution.

Strengths and business risks

Integrated provision from development to support, and has built one of the largest domestic web security databases

1. Strengths

The Company's main strength is that it has built a structure for integrated operation from development to support. As a specialty manufacturer of security software in Japan, it conducts from the collection of information for the core web security database to product planning, development, sales, and support in an integrated manner in-house. This enables it to accurately grasp customer needs and quickly reflect them in development activities. It is also the driving force in creating the factors that differentiate it from its competitors, such as advanced product performance and ease of use. As the result, the Company has captured a large share of the security software market and realizes high customer satisfaction with a repeat rate of 95% or more.

Another strength is that it has established a stable income base using a business model of recurring revenue. As noted above, the web security business uses a business model with recurring revenue by charging a renewal fee (half of the value of the first fiscal year) from the second year onward in order to sustain usage after the first year. This model provides a stable source of income.

Its main competitors include Alps System Integration (ALSI*), and Trend Micro <4704>. Cultural differences serve as a barrier to entry for major foreign companies, which have not sufficiently addressed the Japanese market. Furthermore, as previously explained, the Company is able to provide the latest and highly precise database constantly, and this differentiates it from other companies and sustain its high market share.

* Consolidated subsidiary of Alps Electric <6770> that offers manufacturing and distribution solutions, security solutions, and firmware solutions.

2. Business risks

Two major business risks are the high reliance on sales agents, and the outflow, recruitment, and training of human resources.

The majority of the Group's products are sold to customers via sales agents. Therefore, Group sales might fluctuate substantially based on the sales conditions at the major sales agents and changes in the management environment, such as corporate M&A and bankruptcies. Sales agents also carry competitor products, so there is a possibility of agents handling these products prior to the Company's products. The extent of the reliance on the top two sales agents in FY3/19 (SB C&S and Daiwabo Information System) was 34.5%.

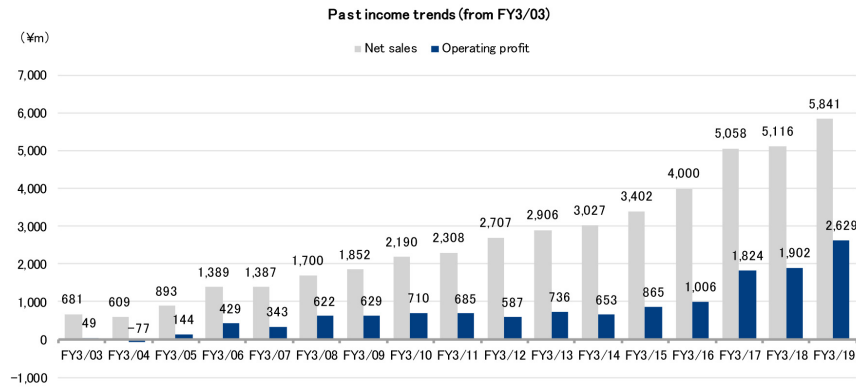
The information security market is currently performing well, and demand for cyber security measures and personal data protection measures is expected to further grow due to the regulatory advances with the Basic Law on Cyber Security, the My Number Law, and the Revised Personal Information Protection Law. The Company, which has the leading market share, is currently benefiting from this environment, in which it is able to obtain business if it has sufficient human resources. Therefore, if an outflow of human resources occurred, it could have a major impact on its business results. In addition, the recruitment and training of human resources is an important issue from the standpoint of growth in the long-term. The Company's current remuneration system is mainly performance-based and employees are methodically evaluated based on results. It has also implemented a stock option system, while it has reported that the average period of employment for its employees was roughly 6 years, as of FY3/19.

Performance trends

Results continue to trend upward alongside the expansion of the product lineup

1. Past results

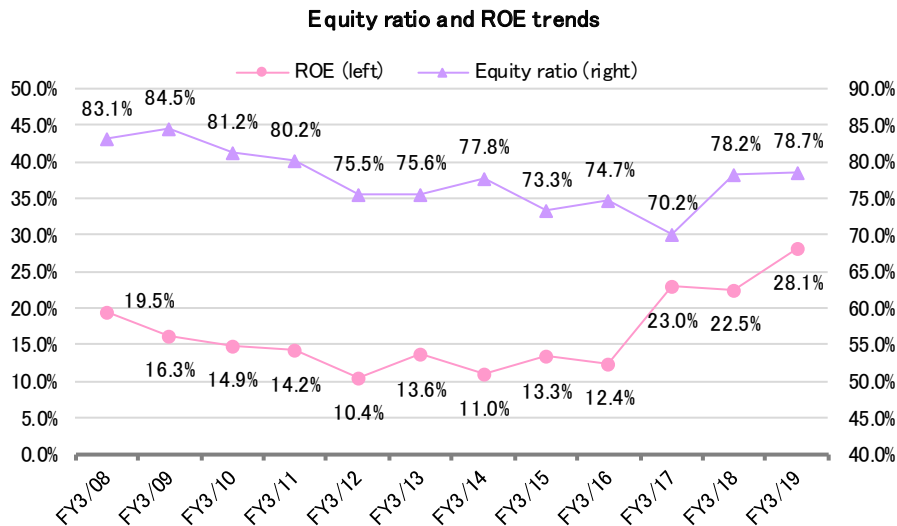
On looking at the past results, we see that sales have consistently grown alongside the expansion of the product lineup. Profits have also largely expanded in line with sales growth, other than the two dip phases: 1) FY3/03 to FY3/04, due to pressure from listing-related costs, the recruitment of additional personnel for business expansion, and investment cutbacks at schools and local government organizations, and 2) FY3/11 to FY3/12, when results were affected by heavy investment in sales promotion costs aimed at expanding in the household market.



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

Looking at the balance sheet, we see that net assets have been accumulating steadily, supported by the stable earnings model with recurring revenue. This is enabling the Company to sustain the equity ratio at over 70%, and its financial position is sound.

Performance trends



Note: Consolidated for the equity ratio from FY3/05 and for ROE from FY3/06
 Source: Prepared by FISCO from the Company's financial results

Results are being driven by the public-sector and household markets, and recorded all-time high sales and profits

2. Review of FY3/19 results

Digital Arts reported FY3/19 consolidated results with all-time high sales and profits, including ¥5,841mn in net sales (+14.2% YoY), ¥2,629mn in operating profit (+38.2%), ¥2,630mn in recurring profit (+37.8%), and ¥1,961mn in net profit attributable to owners of parent (+53.0%).

The Company has been highly evaluated for its track record and the reliability it has accumulated as a manufacturer of security software to prevent leaks regarding internal information, and sales progressed of i-FILTER Ver.10 and m-FILTER Ver.5, which make possible advanced security measures, including against targeted attacks, and they contributed to the growth of results. In particular, in the public-sector market, its presence as a manufacturer of comprehensive security measures has increased. Results are also trending stably in the mainstay corporate market, and it is acquiring projects for FinalCode, which had temporarily slumped, including acquiring its largest ever project. In the household market as well, alongside the revisions to the Act on Development of an Environment that Provides Safe and Secure Internet Use for Young People, progress is being made for the introduction of filtering for smartphone use, mainly for young people, and this is contributing to the growth in results.

Performance trends

Overview of FY3/19 results

	FY3/18		FY3/19				
	Actual	Ratio to sales	Actual	Ratio to sales	YoY change	Period-start guidance	Change from period-start plan
Net sales	5,116	-	5,841	-	14.2%	5,800	0.7%
Cost of sales	1,075	21.0%	1,059	18.1%	-1.5%	-	-
SG&A expenses	2,138	41.8%	2,152	36.9%	0.7%	-	-
Operating profit	1,902	37.2%	2,629	45.0%	38.2%	2,500	5.2%
Recurring profit	1,909	37.3%	2,630	45.0%	37.8%	2,500	5.2%
Net income attributable to owners of parent	1,281	25.1%	1,961	33.6%	53.0%	1,619	21.1%

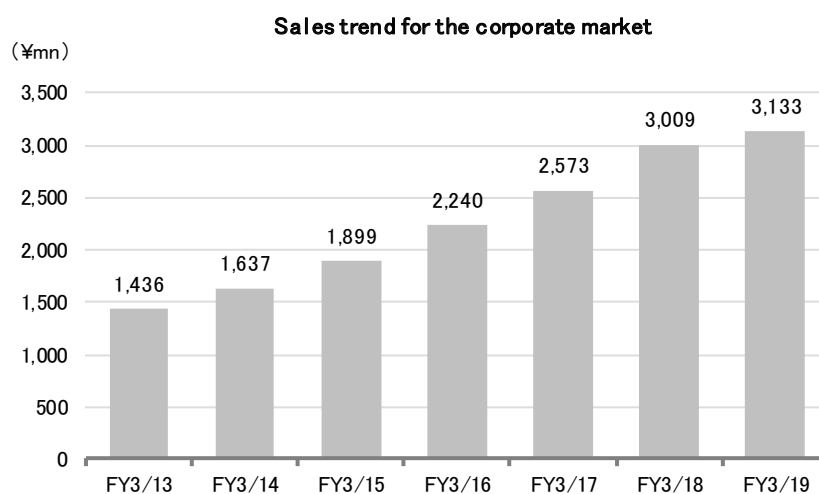
Source: Prepared by FISCO from the Company's financial results

Although depreciation costs increased following the releases of new products, cost of sales decreased ¥15mn YoY due to a decrease in labor costs, and the cost of sales ratio improved 2.9 percentage points (PP). As for SG&A expenses, there was a rise in remuneration paid to external experts for the reorganization following the review of the overseas strategy, however this was kept down to only ¥14mn YoY. As a result of these factors, the Company progressed the selection and concentration of management resources and improved efficiency, and the operating margin rose by 1.0 PP to 38.2%.

3. Trends by market segment

(1) Corporate market

Sales to the corporate market were solid, up 4.1% YoY to ¥3,133mn. Sales were strong for the mainstay m-FILTER products through the steady acquisition of projects, centered on projects continuing from the previous fiscal year. For FinalCode, projects that had temporarily stagnated became active, due to the addition of the Browser View function that had been highly requested since the past, and the Company acquired its largest ever project. Also, the percentage of total sales from the cloud services-based product i-FILTER rose, and the amount of orders not yet recorded as sales grew.

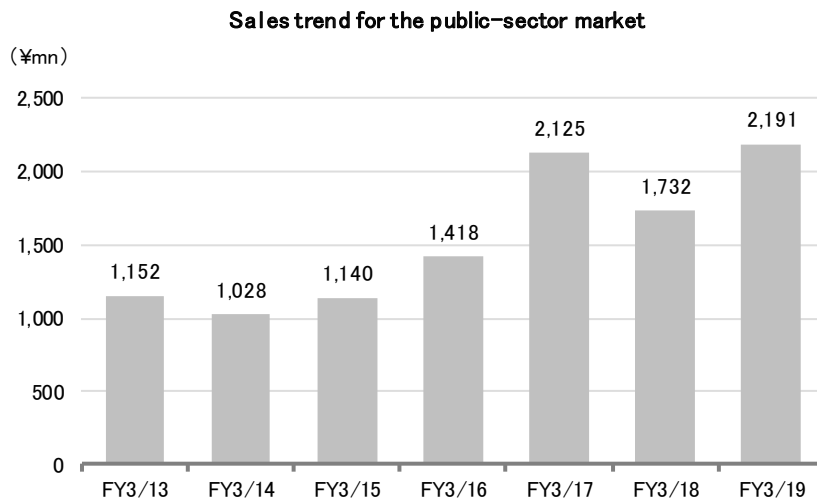


Source: Prepared by FISCO from the Company's results briefing materials

Performance trends

(2) Public-sector market

Sales for the public-sector market grew significantly, up 26.5% YoY to ¥2,191mn, which drove the results of the Company as a whole. The Company has been highly evaluated for its track record and the reliability it has accumulated as a manufacturer of security software to prevent leaks regarding internal information, and sales progressed of i-FILTER Ver.10 and m-FILTER Ver.5, which make advanced security measures, including against targeted attacks possible. Through this, in advance of in the corporate market, its presence as a manufacturer of comprehensive security measures has increased in this market.

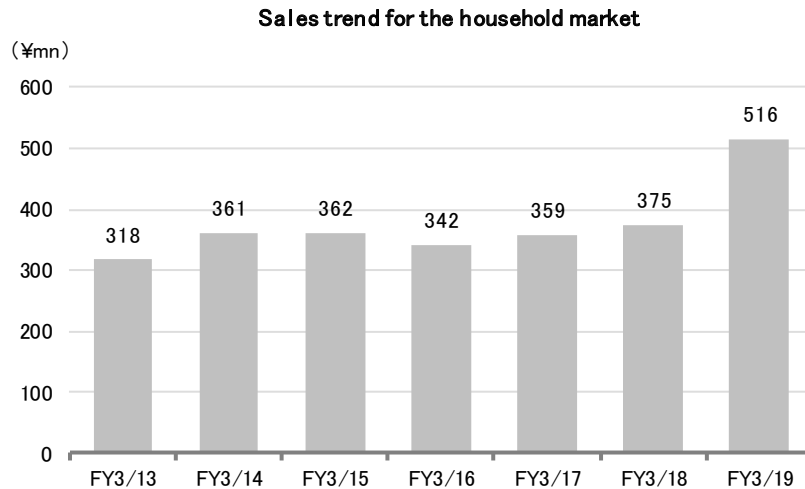


Source: Prepared by FISCO from the Company's results briefing materials

(3) Household market

Sales for the household market increased significantly, up 37.4% YoY to ¥516mn, and drove the results of the Company as a whole. In February 2018, the Act on Development of an Environment that Provides Safe and Secure Internet Use for Young People was revised, and management to introduce filtering for young people, which had been an obligation since the past, was made even stricter. Along with this revision, the introduction of filtering for smartphones through mobile carriers went forward and contributed to the growth of results.

Performance trends



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

The Company's equity ratio remained above 70% as it prepares for growth investments with an abundance of cash

4. Financial status and management indicators

At the end of FY3/19, total assets were up ¥1,930mn from the end of the previous fiscal year to ¥9,859mn. Breaking this down, current assets increased ¥2,022mn from the end of the previous fiscal year, mainly because cash and deposits rose (¥1,742mn) alongside the business expansion. Liabilities were up ¥375mn from the end of the previous fiscal year to ¥2,056mn due to higher prepaid amounts (¥308mn). Net assets rose ¥1,555mn from the end of the previous fiscal year to ¥7,802mn, which was primarily due to the increase in retained earnings following the recording of net profit attributable to owners of parent. Looking at cash flow conditions, at the end of FY3/19, cash and cash equivalents had risen ¥1,742mn from the end of the previous fiscal year to ¥5,569mn. Cash flow from operating activities had a net surplus of ¥3,091mn due to the recording of net profit before taxes and adjustments of ¥2,563mn, and amortization costs of ¥662mn. Cash flow used in investing activities had a net deficit of ¥908mn, because of acquiring intangible fixed assets worth ¥741mn. Also, cash flow used in financing activities reported a net deficit of ¥429mn because of dividend payments of ¥444mn and other items. Looking at the management indicators, the equity ratio, which indicates financial soundness, increased to 78.7%, up 0.5 PP from the end of the previous fiscal year, because the growth rate of net assets exceeded the growth rate of total assets, due to the retained earnings. The current ratio also improved 35.6 PP to 384.5%. The Company maintained both indicators at high levels and moreover has zero interest-bearing debt, so it has absolutely no problems in terms of financial soundness. For ROA, ROE, and the operating margin, which indicate profitability absorbed the burden of upfront investment and improved to even higher levels. The Company has an abundance of cash that will enable it to flexibly invest in growth, including in M&A.

Performance trends

Balance sheet, cash flow statement, and management indicators

	FY3/18	FY3/19	Change	Main reason for the change
	(¥mn)			
Current assets	5,707	7,729	2,022	Cash and deposits+1,742
Fixed assets	2,220	2,129	-91	
Total assets	7,928	9,859	1,930	
Current liabilities	1,635	2,010	374	Prepaid amounts+308
Fixed liabilities	45	46	1	
Total liabilities	1,680	2,056	375	
Net assets	6,247	7,802	1,555	Surplus profit+1,526
Liabilities and net assets (total)	7,928	9,859	1,930	
Interest-bearing debt	-	-	-	
(net cash)	4,426	6,469	2,042	
Stability				
Current ratio	348.9%	384.5%	35.6pt	
Equity ratio	78.2%	78.7%	0.5pt	
Interest-bearing debt ratio	0pt	0pt	0pt	
Profitability				
ROA (return on assets)	24.9%	29.6%	4.7pt	
ROE (return on equity)	22.5%	28.1%	5.6pt	
Operating margin	37.2%	45.0%	7.8pt	
Cash flow from operating activities	1,663	3,091	1,428	
Cash flow from investing activities	-774	-908	-133	
Cash flow from financing activities	-293	-429	-136	
Cash and cash equivalents	3,826	5,569	1,742	

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

■ Outlook

Company forecasts are slightly conservative for FY3/20 with possible upside

1. Outlook for FY3/20

The Company is forecasting higher sales and profits for FY3/20, with net sales to increase 16.4% YoY to ¥6,800mn, operating profit to rise 25.5% to ¥3,300mn, recurring profit to grow 25.4% to ¥3,300mn, and net profit attributable to owners of parent to climb 16.1% to ¥2,277mn. The percentage of total net sales provided by cloud services-based products trended upward in the previous fiscal period and this trend is forecast to further accelerate in FY3/20, while it seems that the Company formulated the initial budget expecting conservative financial adjustments. The contracts amount is forecast to be worth ¥7.5bn.

Outlook

Overview of FY3/20 forecast

	FY3/19		FY3/20		
	Actual	Ratio to sales	Plan	Ratio to sales	YoY change
Net sales	5,841	-	6,800	-	16.4%
Cost of sales	1,059	18.1%	1,350	19.9%	27.4%
SG&A expenses	2,152	36.9%	2,150	31.6%	-0.1%
Operating profit	2,629	45.0%	3,300	48.5%	25.5%
Recurring profit	2,630	45.0%	3,300	48.5%	25.4%
Net profit attributable to owners of parent	1,961	33.6%	2,277	33.5%	16.1%

(¥mn)

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

Cost of sales is forecast to increase 27.4% YoY to ¥1,350mn due to the expected rises in depreciation expenses following the releases of new products, and in labor costs as the Company will recruit more engineers and consultants. SG&A expenses are expected to rise organically in Japan, however they will remain around the same level as the previous fiscal year because the remuneration paid to external experts and others for the reorganization of overseas bases will decrease in FY3/20.

At FISCO, we think that the Company's forecast are conservative and there is room for results to exceed them, in light of 1) the Company tends to sets conservative values for its initial forecasts 2) the sales conditions of the mainstay products, i-FILTER Ver.10 and m-FILTER Ver.5, continue to be steady, 3) in the corporate and public-sector markets, the percentage of sales from cloud services-based products rose, and sales were slightly sluggish in the previous fiscal period, but this has already been incorporated into the FY3/20 forecasts; 4) the Company is enhancing its product lineup, including the new functions of FinalCode, and is acquiring momentum to grow sales through cross sales to companies that have not introduced all of its services.

2. Market environment and priority initiatives

The market environment for the security industry is on a global scale, not just in Japan, and the threats from external attacks, such as targeted attacks against specific companies, organizations and government agencies, are becoming more diverse and sophisticated, so new responses to counter these new threats are essential. In this sort of environment, the trends of the outsourcing of security operations and the shift to the Cloud of security products that reduce the operational burden are accelerating, and new needs are growing, including for the Olympics and Paralympic Games, IoT, automated driving, and work-style reforms.

(1) Strengthening and growing sales of the i-FILTER Ver.10, m-FILTER Ver.5, and FinalCode products

Threats from external attacks, including targeted attacks, are becoming more diverse and sophisticated. So the Company is focusing on strengthening the functions and growing sales of its mainstay products, for effective countermeasures against these new threats. In particular, customers are recognizing the value of i-FILTER Ver.10 and m-FILTER Ver.5, and compared to the unit prices of the previous versions, the Company is receiving orders with contract unit prices of 4.6 times higher for i-FILTER and 1.8 times for m-FILTER. Even if only 30,000 companies of the 3 million existing companies in Japan introduce the Company's product, it can be estimated that 1% alone could achieve annual sales of ¥10bn, which is very promising in terms of the Company's potential.

For the sales channels, sales of under 1,000 licenses are mainly via retailers, and the Company is targeting as a priority companies with 10,000 licenses or more, which contribute greatly to sales.

Outlook

(2) Strengthening and expanding sales of DigitalArts@Cloud products

The Company has started to provide services by shifting the security products onto the Cloud, with the aim of reducing the operational burden. The sales channels are the leading Cloud service providers, including RICOH and So-net.

(3) Strengthening and expanding sales of FinalCode products

The Company has newly added a Browser View function, which enables users to browse files free of charge without having to install client software. In addition, on June 27 it began providing FinalCode Ver.6, which is equipped with a transparent encryption function. Through this new function, automatic encryption is performed when a file is created and saved on a personal PC terminal or when a file is downloaded from the system, and unauthorized internal removals can be prevented. In addition, it is planning measures such as offering inexpensive prices (half the current price) that can be easily applied to large-scale proposals.

■ Medium- to long-term management strategy

Entering a new growth stage

The Company does not disclose specific targets as it does not disclose a medium-term business plan. However, it has set a management target of net sales of ¥10bn by FY2020 (FY3/21) as a result of steadily implementing a policy of “contributing to a more convenient, more comfortable, and safer Internet life.” This is roughly double the level of net sales in FY3/17, and therefore looks like a very high target at first glance with approximately 20% in average annual growth. However, given that we view the Company’s FY3/20 forecast for 16.4% YoY sales growth as slightly conservative, and that sales grew 14.2% YoY in FY3/19, we think that it is fully capable of achieving this target by FY2020.

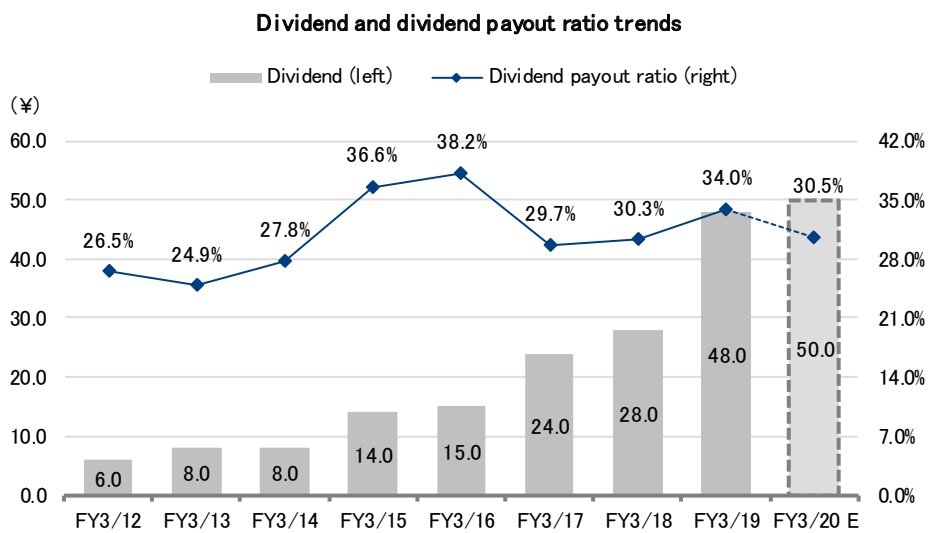
For its long-term management strategy, the Company is aiming to increase sales through prioritizing the allocation of business resources to the security business, mainly driven by development and sales activities for web security software and email security software. At the same time, it plans to pursue management reforms that will create profits by improving organizational efficiency and reducing costs, mainly expenses.

At FISCO, we think the Company is entering a new growth stage when considering factors such as the progress it has made in acquiring local governments and major companies as customers, and the steady sales of i-FILTER (Ver.10) and m-FILTER (Ver.5). Going forward, toward achieving net sales of ¥10bn by FY3/21, it will focus on developing new products, accelerating the growth of sales to companies that have not yet introduced security measure products, and expanding the business scale, including M&A.

Shareholder return policy

Continuing a stable dividend with a 30% payout ratio

For returns to shareholders, the Company's basic policy is to stably and continuously pay dividends while retaining the internal reserves necessary to secure the funds to further strengthen its business foundation and prepare for the spread of web security, e-mail security, and other information security software, with the prospect of the rapid market expansion. Therefore, it targets a dividend payout ratio of approximately 30% of consolidated net profit. The FY3/19 dividend was ¥48 (dividend payout ratio, 34.0%), while for FY3/20, it is forecasting a dividend of ¥50 for a dividend payout ratio of 30.5% (with a ¥25 interim dividend).



Note: Implemented a stock split of 1:100 shares on April 1, 2013.
 Source: Prepared by FISCO from the Company's financial results

Information Security

The Company is a manufacturer of information security products that conducts the planning, development, and sales of Internet security-related software, so naturally it strictly manages the information it handles, including its customers' personal information. Therefore, it has established its own Basic Policy for Information Security and Policy for Protection of Personal Information, and it is working to construct a management organization system, implement and maintain measures, and continuously improve them.

As a part of these efforts, the Company acquired the PrivacyMark certification in February 2008 and ensuring the secure handling of information.

* Information Security Management System (ISMS) is a comprehensive information security management system for protecting information assets from various threats and reducing risks. There are both international and domestic ISMS standards (ISO/IEC 27001/JIS Q 27001), and meeting these standards and obtaining certification is generally called "acquiring ISMS".

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