Dynam Japan Holdings
06889 Hong Kong Stock Exchange

24-Jun.-16

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Continuing a business offensive based on low-cost operations and other strengths inherent in a listed company

Dynam Japan Holdings Co., Ltd. (HK06889) is one of Japan's largest operators of pachinko and pachinko slot halls with the largest number of halls operated and the second largest in terms of ball rental fee revenue. Its strength and characteristics lie in its low-cost operations based on chain-store theory, which it thoroughly applies to newly opened halls as well as to daily hall operations. In addition, the Company was the first in its industry to be listed on a stock market, which is a result of its management having won recognition for its full enforcement of a customer-first creed, information disclosure, compliance management, and other factors.

The Japanese market for pachinko and pachinko slot halls continues to shrink, but the Company maintains its traditional growth strategy of pursuing low-cost operations based on chain-store theory and taking advantage of its ability to raise funds as a listed company to overcome the challenges posed by industry consolidation. The Company aims to increase its profits by expanding its network of halls through organic growth and M&A.

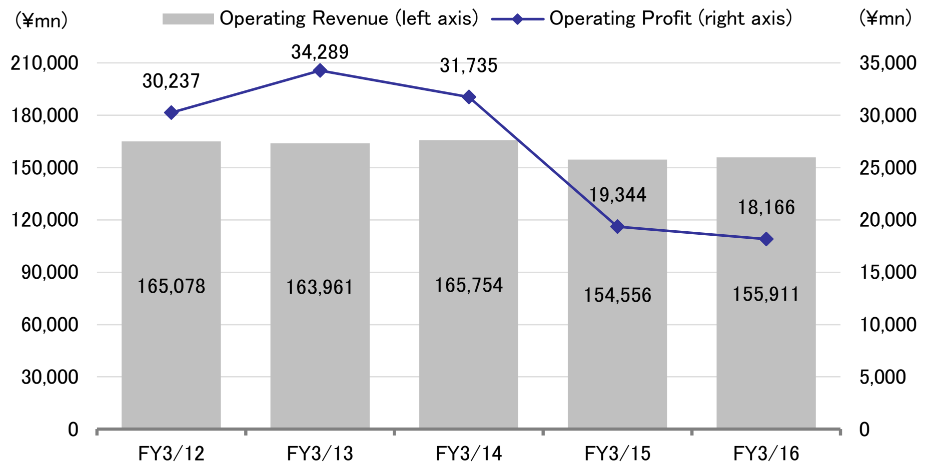
In November 2015, Dynam Japan Holdings acquired Yume Corporation through a share exchange, thereby adding 39 pachinko and pachinko slot halls to its network at an average cost of about ¥1.5mn per hall. We consider this acquisition to have been a great success because the average cost of the halls added was less than one-third the Company’s cost of opening a new hall independently. Amid an increasingly competitive operating environment, the Company is likely to make similar acquisitions in the future, as it is one of the few companies in its industry capable of such transactions.

In the fiscal year through March 2016, i.e., in FY3/16, the Company essentially maintained a constant EBITDA year on year (YoY) even though the market for pachinko and pachinko slot halls continued to contract. The Company has released no forecasts for FY3/17, but its business prospects are clouded by a number of uncertainties, including the impact of gambling restrictions on returns from pachinko machines. Yume Corporation was consolidated for only the final five months of FY3/16, but will be consolidated for all of FY3/17. This should contribute to sales growth. However, overall sales and profit growth will depend on how much the consolidation of Yume Corporation offsets the impacts of adverse factors affecting the market.

Check Point

- A challenging operating environment offers chances to grow and increase market share in a consolidating industry
- The Company will aggressively increase its M&A of companies meeting its investment criteria
- The Company will buy back some of its outstanding shares to enhance shareholder returns

Trend in Operating Results



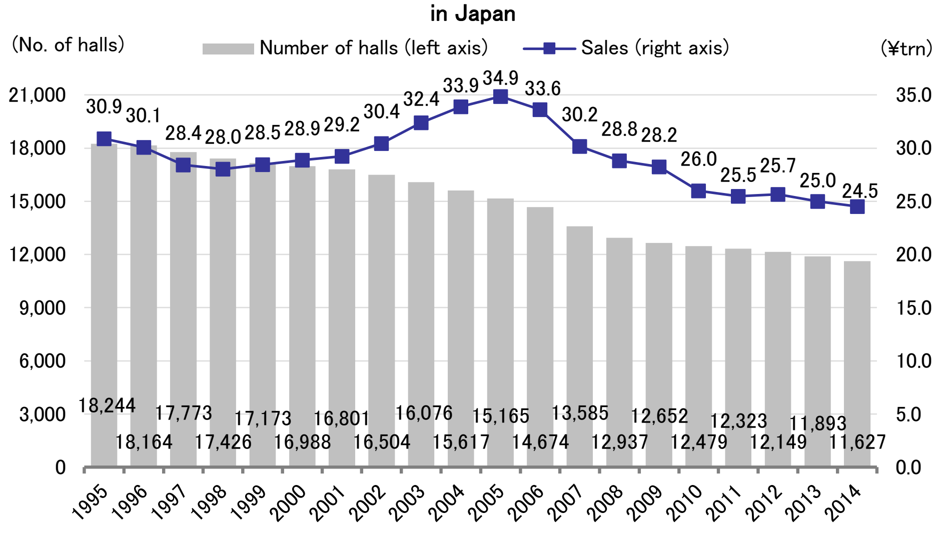
State of Japan's pachinko hall industry

Proliferation of smartphones has cut into Japan's population of pachinko players during leisure time

At the end of 2015, there were 11,310 pachinko and pachinko slot halls in Japan, 317 (2.7%) fewer than at the end of 2014. At the end of 1995, there had been 18,244 pachinko and pachinko slot halls in operation. Thus, there was 38.0% fewer halls at the end of 2015 than there had been 20 years earlier, for an average YoY decline of 2.4% during this period.

Reflecting this decline in the number of pachinko and pachinko slot halls and a drop in the pace of hall use, Japan's pachinko and pachinko slot market has been shrinking. Pachinko ball rental revenue, which is equivalent to gross sales in the industry, came to ¥24,504bn in 2014, which was 20.7% less than revenue in 1995 and 29.7% less than peak revenue in 2005.

Number of pachinko and pachinko slot halls and pachinko industry sales in Japan



Source: Prepared by FISCO from National Police Agency figures and the "Leisure White Paper 2015" published by the Japan Productivity Center

The shrinkage of Japan's pachinko and pachinko slot hall market has been due mainly to a decrease in the number of pachinko players. In 2014, Japan's pachinko playing population increased 18.6% YoY to 11.5mn people, but this was 60.3% smaller than the population in 1995, a much larger rate of decline than the falls in sales and the number of halls. The pachinko playing population decreased by an average annual rate of 4.8% between 1995 and 2014. Industry sales declined at a smaller rate than the playing population because hardcore players spent more money on the pursuit. However, the number of new players, particularly young new players, did not increase, and many occasional players stopped playing.

The causes of the decline in the pachinko population vary with time, but in recent years the proliferation of smartphones is believed to have been a major factor in Japan. The use of smartphones has apparently reduced the leisure time available to play pachinko and has made pachinko less attractive to the younger generation.

Japan's economy and regulations are also stymieing the growth of the pachinko and pachinko slot hall industry. In April 2014, Japan raised its consumption tax from 5% to 8%. As a result, from summer 2014, the number of pachinko players fell sharply. To counter the impact of this fall, pachinko halls giving priority to profits lowered their ball discharge rate, which is the cost of prizes relative to ball rental fee revenue, i.e., a measure of returns to customers. This, in turn, drove away more customers in a downward spiral. In autumn 2015, regulations imposed on machines considered to be overly risky in terms of returns to customers were strengthened. This may further reduce the pachinko playing population.

■ Strengths and growth strategy of the Dynam Group

A challenging operating environment offers chances to grow and increase market share in a consolidating industry

We believe that some operators of pachinko halls can grow despite the contraction of the Japanese market for pachinko and pachinko slot halls because the market is very fragmented. Although Dynam Japan Holdings has the largest number of halls in the industry, it held only about 4% of the 11,310 halls in operation at the end of 2015. The difficult operating conditions in the industry are driving competitors to strive for survival. However, these conditions provide opportunities for stronger companies to grow and increase their market shares.

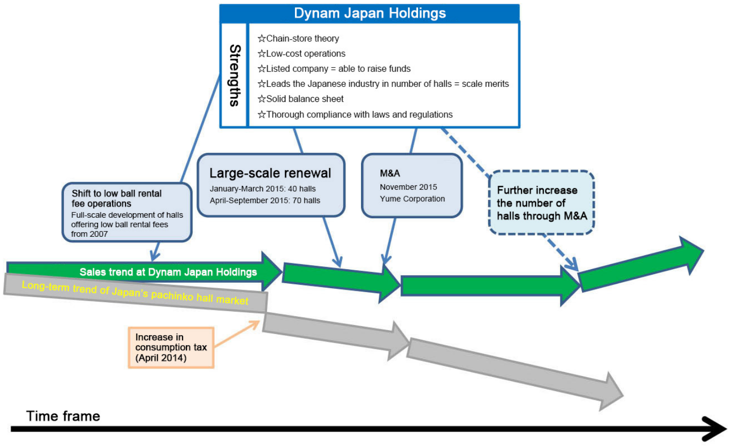
The trend of decline in Japan's market for pachinko and pachinko slot halls has been apparent for at least 10-15 years. Early in the process, the Company recognized that this would become a long-term trend, prompting it to adopt a strategy of using its strengths to expand its hall network and its market share.

We believe that the Company possesses the strengths to achieve its goals. Its core strength is in its low-cost operations based on chain-store theory. Using this strength, the Company has been enhancing the attractiveness of its halls by expanding its low ball rental fee operations and renewing its halls on a large scale.

As a listed company, Dynam Japan Holdings acquired Yume Corporation through a share exchange. We believe that this was just one example of the Company's model for future growth (we discuss the development of the group below).

Although the pachinko hall industry has shrunk, it is still huge, at about ¥25trn per year. This is big enough for the Company and other leading companies in the industry to grow even if the industry contracts further. We believe that the Company can return to a growth path by taking advantage of its strengths described above. Below, we discuss some of the important points about its strengths.

Diagram of Dynam Japan Holdings' important policies and growth strategy



Source: FISCO Ltd.

(1) Low-cost operations based on chain-store theory

Yoji Sato, former chairman and chief executive officer of the Company, is primarily responsible for the introduction of the Company's chain store operational style. After graduating from a university, he entered the supermarket chain operator Daiei, having been impressed by the chain store theory that was being adopted in Japan at the time. He subsequently succeeded his father, who had established the precursor of Dynam Japan Holdings, and thoroughly applied the chain-store theory into all aspects of the Company's operations, making it the top operator of pachinko and pachinko slot halls in Japan. He also established the Pachinko Chain Store Association with other companies operating pachinko halls according to the chain-store theory.

FISCO believes that low-cost operations are needed for a pachinko hall operator to thrive in a consolidating industry. Without them, the company may not be able to implement policies to attract customers as planned and it may not be able to overcome sudden obstacles, such as a tightening of regulations. Dynam Japan Holdings operates its halls at low cost applying principles of operating chain stores.

The Company operates all its halls at low cost. Most of its new halls are standard-model wooden structures built along roadsides offering low ball rental fees. They have standard interior layouts and the uniform number of machines. Thus, their costs of materials and construction are low and they can be constructed in a short period of time at little initial cost.

Standard model for opening new halls

Factors	Baseline	Remarks
Target area population	30,000-50,000	Promote suburban strategy
Hall type - land	20-year fixed term land leasehold	Avoid large investment to buy land
Hall type - buildings	One-story wooden buildings	Easy to scrap in the future
Number of machines	480	Standardize the hall interior layout and number of machines
Initial investment	¥500mn or less	Limit costs by opening halls in suburban areas of smaller cities
Return target	ROI of 25% or more	ROI target is 10-year average

Source: prepared by FISCO from Company materials

To lower the operating cost of the existing halls, it is important to reduce their personnel cost. The costs of personnel and machines constitute a large portion of the total cost of operating a pachinko hall. However, operators of pachinko halls have little latitude to lower their machine costs. They must install popular machines, so it is difficult to greatly distinguish one operator from another through the cost of machines. The Company has reduced the average number of staff per hall by introducing "personal systems" (ball counters at each machine) and managing these systems with computer systems.

Personal systems record on cards the number of balls (tokens) won by a customer. The use of these systems obviates the need for customers to keep their balls in stacked boxes on the floor and the need to take the boxes on trollies to the counter to exchange balls for prizes. Ordinarily, 6-7 regular employees and 20 part-time employees are needed to operate a pachinko hall over three shifts. By using personal systems, Dynam Japan Holdings can reduce the number of part-time employees by 6-7 persons (2 persons per shift) to operate a hall. We estimate that almost 90% of the Company's low ball rental fee halls (low playing cost halls) have installed personal systems.

(2) Low ball rental fee operations

Low-cost operations help to maintain profitability and therefore protect business, but to increase sales, the company has adopted a strategy of operating halls offering low ball rental fees.

Pachinko is played by 'renting' the balls and this ball rental fee (the fee for renting the balls from the hall side) conventionally has been set at ¥4 per ball. In other words, the customer would rent 250 balls for ¥1,000. But in the low ball rental fee operational strategy being moved ahead by the Company, this ball rental fee is reduced to ¥1 or ¥2. The idea in the case of ¥1 balls is that the customer can rent 1,000 balls for ¥1,000 and so can play for a long time just be spending this relatively small amount, which should help to attract customers.

In fact, data shows that the Company's halls offering low ball rental fees have attracted more customers than its halls charging higher fees. Over the past few years, the Company's total ball rental fee revenue and total operating revenue generated by halls charging high ball rental fees have declined, while both totals for halls charging low fees have risen. This trend persists on a per-hall basis, which eliminates the impact of changes in the number of halls on total revenue. Per-hall revenue from halls charging high ball rental fees have declined significantly, while revenue from halls charging low fees have risen or declined only slightly.

Comparison of revenue generated by the Company's halls based on ball rental fees, FY3/13–FY3/16

(¥mn)

		FY3/13	FY3/14		FY3/15		FY3/16	
		Full year	Full year	YoY	Full year	YoY	Full year	YoY
Ball rental fee revenue	Total	929,158	922,172	-0.8%	826,072	-10.4%	844,885	2.3%
	Halls charging high ball rental fees	716,842	668,586	-6.7%	554,341	-17.1%	539,205	-2.7%
	Halls charging low ball rental fees	212,316	253,586	19.4%	271,732	7.2%	305,680	12.5%
Operating revenue	Total	163,961	165,754	1.1%	154,556	-6.8%	155,911	0.9%
	Halls charging high ball rental fees	107,307	104,121	-3.0%	90,727	-12.9%	84,097	-7.3%
	Halls charging low ball rental fees	56,654	61,633	8.8%	63,829	3.6%	71,814	12.5%
Number of halls at term-end	Total	362	375	3.6%	393	4.8%	442	12.5%
	Halls charging high ball rental fees	174	173	-0.6%	172	-0.6%	185	7.6%
	Halls charging low ball rental fees	188	202	7.4%	221	9.4%	257	16.3%
Average ball rental fee revenue per hall	Total	2,591	2,502	-3.4%	2,151	-14.0%	2,023	-5.9%
	Halls charging high ball rental fees	4,096	3,853	-5.9%	3,213	-16.6%	3,020	-6.0%
	Halls charging low ball rental fees	1,157	1,300	12.4%	1,284	-1.2%	1,279	-0.5%
Average operating revenue per hall	Total	457	449	-1.6%	402	-10.5%	373	-7.2%
	Halls charging high ball rental fees	613	600	-2.1%	526	-12.4%	471	-10.4%
	Halls charging low ball rental fees	308	316	2.4%	301	-4.5%	300	-0.4%

Note: Average revenue per hall is based on the full-term revenue divided by the average number of halls in operation during the term, i.e., the number at the end of the period minus the number at the start of the period divided by two.
Source: prepared by FISCO based on company materials

As shown in the table, operating revenue, or net sales, per hall is much higher for halls charging high ball rental fees than for halls charging low fees, reflecting the disparity in ball rental fees. This is a natural result, because, for example, it is the same thing as if a supermarket was selling identical items at two to four times' the price.. As the operating costs for both types of hall are about the same, halls charging low ball rental fees are less profitable than halls charging high fees. Thus, the Company faces the dilemma of whether to pursue profitability or try to attract more customers.

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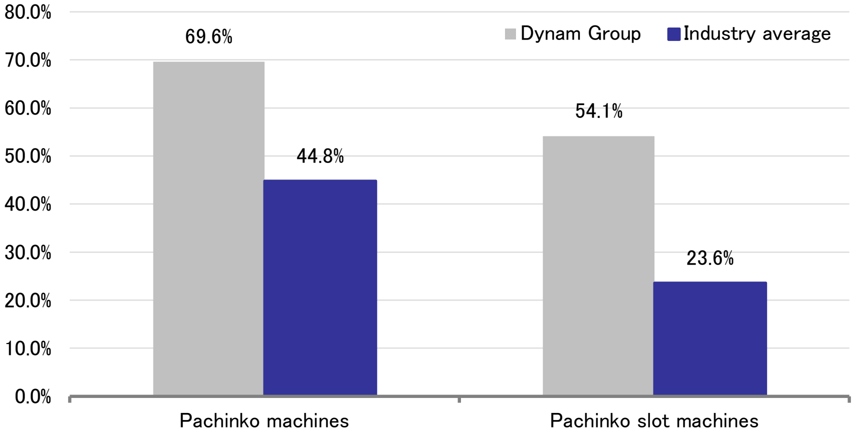
Japan's pachinko hall industry has been rapidly adopting low ball rental fees. To undertake this strategy without reducing profits, a company must be strong enough to increase the number of halls in operation. In practice, companies must balance the number of halls charging low ball rental fees and the number charging high fees.

In both pachinko hall operations and pachinko slot hall operations, the Company has a higher proportion of machines charging low ball or token fees than the average proportions for the industry because the Company has intentionally applied its strengths (low-cost operations, number of halls, funding capability, etc.) to outdistance competitors in this respect. As discussed later, these strengths will probably enable the company to respond positively to a tightening of restrictions on high-risk gaming.

Comparison of ratios of the number of machines charging low fees to the total number of machines, Dynam Japan Holdings versus the Japanese industry



Source: prepared by FISCO based on company materials

■ Main developments of 2015 and goals hereafter

The Company will aggressively increase its M&A of companies meeting its investment criteria

(1) Acquisition of Yume Corporation

On November 1, 2015, the Company conducted a share exchange of all shares and acquired Yume Corporation, which has its head office in Toyohashi City, Aichi Prefecture. Yume Corporation has a total of 39 halls; 38 Yumeya brand pachinko halls as a nationwide network from Hokkaido to Kyusyu, and 1 SLOT PARK GOD brand pachinko slot hall geared to women. The same as the Company, Yume Corporation manages its pachinko halls based on chain-store theory and is a corporate member of the Pachinko Chain Store Association (PCSA). This was one of the reasons why the Company decided to acquire it.

Yume Corporation does not disclose its financial results, but it seems to be stably achieving profits. For the share exchange, Dynam Japan Holdings issued approximately 38.8mn new shares. Using the share price and exchange rate as of October 30, 2015, the market value of the new shares was estimated to be ¥5,775mn. Dividing this by the number of halls acquired, the Company paid ¥148mn per hall. Considering that in the Company's standard model, the cost of newly opening a hall is around ¥500mn, this acquisition can be evaluated as extremely efficient in terms of an investment in halls.

Details of the share exchange

Company name	Dynam Japan Holdings	Yume Corporation
Share-exchange ratio	1	3.466
No. of shares issued in the share exchange	38,805,336 shares	

Source: prepared by FISCO based on company materials

Yume Corporation was a consolidated subsidiary of Dynam Japan Holdings for the final five months of FY3/16. For those five months, Yume Corporation reported ball rental fee revenue of ¥29,297mn and operating revenue of ¥5,703mn. Annualizing these figures, ball rental fee revenue would amount to ¥70,313mn and operating revenue would come to ¥13,687mn. Yume Corporation did not report its profits, but based on the assumption that it earns an operating profit margin of 10%, it should supply an operating profit of ¥1,369mn per full fiscal year. The acquisition pushed the total number of the Company's halls to more than 440, and the Company estimates that merits of scale resulting from the acquisition of Yume Corporation's halls should lower the Company's operating costs by about ¥700mn per year.

When Yume Corporation was acquired, it operated 39 halls, of which 10 were equipped with machines charging high ball rental fees and 29 were equipped with machines charging low ball rental fees. At the end of April 2016, Yume Corporation closed its Tsunoda hall in Miyagi Prefecture, but it plans to operate its remaining halls under their current brand names. The breakdown of Yume Corporation's halls by number of low playing cost halls and high playing cost halls is similar to the breakdown for the Company, so we estimate that Yume Corporation's profitability could be similar to the Company's profitability.

We find the Company's acquisition of Yume Corporation to be ideal for four reasons: 1) Yume Corporation operates its halls according to principles of chain-store management, 2) Yume Corporation is apparently highly profitable, 3) Yume Corporation brought 39 halls fairly equally distributed throughout Japan to the Company, and 4) the Company was able to optimize the merits of being listed to make the acquisition through a share exchange. Few other potential acquisition targets offer the attractions of Yume Corporation, but given the increasingly difficult operating environment in Japan's pachinko industry, we expect a similarly attractive target to emerge in the future. We also expect the Company to consider aggressive expansion through the M&A of other companies meeting its standards for investment.

(2) Implementation of a large-scale renewal

As mentioned previously, the increase in Japan's consumption tax in April 2014 caused a negative chain of events that led to a drop in the number of pachinko customers. To counter the impact of this chain of events, the company launched a large-scale renewal of its halls, renovating 40 halls in FY3/15 Q4, and 70 halls in 1H FY3/16, for a total of 110 hall renewals.

The 40 halls renovated in the second half of FY3/15 and 63 of the 70 halls renovated in the first half of FY3/16 were high playing cost halls, while 7 of the halls renovated in the first half of FY3/16 were low playing cost halls. The Company concentrated on renovating its high playing cost halls because many of these halls were quite old, reflecting the Company's emphasis on opening new low playing cost halls and converting its high playing cost halls into low playing cost halls. In addition, the Company anticipated greater profits from the renovated high playing cost halls if it could attract customers to them since these halls are much more profitable than low playing cost halls.

The Company aimed to renovate all main interior and exterior components of its halls, including floors, wall cloths, toilets, exterior walls, other exterior items, advertising towers, parking lots (paving/line drawing), and seats. It installed new toilets in more than half of the renovated halls and re-floored some. In addition, at almost all of the halls, the exterior walls, exterior areas, and advertisement towers were renewed, while the seats, modesty panels and end plates were also renewed at most of the halls which went on renewal. These large-scale renewals made the halls appear as if they were newly opened. The renovation cost varied by hall, but we estimate that it was ¥30-50mn per hall, or about ¥5.0bn for 110 halls.

The number of customers at the renewed halls increased, relative to the number before renovation, but we estimate that this was a short-term increase because the Company's rental ball fee revenue and operating revenue from halls charging high ball fees declined YoY in FY3/16.

Revenue generated by hall type, FY3/15-FY3/16

(Unit: ¥mn)

		FY3/15			FY3/16		
		Full year	YoY	Ratio to total	Full year	YoY	Ratio to total
Ball rental fee revenue	Total	826,072	-10.4%	100.0%	844,885	2.3%	100.0%
	Halls charging high ball rental fees	554,341	-17.1%	67.1%	539,205	-2.7%	63.8%
	Halls charging low ball rental fees	271,732	7.2%	32.9%	305,680	12.5%	36.2%
Operating revenue	Total	154,556	-6.8%	100.0%	155,911	0.9%	100.0%
	Halls charging high ball rental fees	90,727	-12.9%	58.7%	84,097	-7.3%	53.9%
	Halls charging low ball rental fees	63,829	3.6%	41.3%	71,814	12.5%	46.1%

Source: prepared by FISCO from Company materials

However, we do not evaluate the Company negatively for having used its strong balance sheet and other competitive advantages to comprehensively renovate its halls. The failure of the renovated high playing cost halls to increase the number of their customers consistently reflected many factors, including a decline in the number of pachinko players in general and, as described below, increased regulations on high-risk games. If these factors subside in the future, the renovated halls may become more attractive to customers than nearby competing halls.

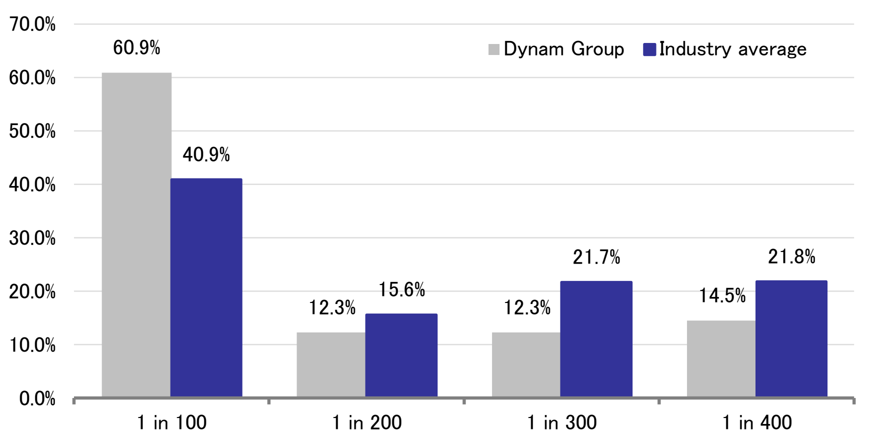
Machines offering lower-risk games in short supply as industry grapples with tighter regulations on high-risk games

(3) Response to regulations on high-risk games

In October 2015, Japan's pachinko industry adopted new regulations on machines offering high-risk games. These regulations lowered the upper limit of acceptable risk and obliged pachinko halls to scrap machines that reach or exceed the new limit.

Pachinko machines vary by the chance of winning. The lowest chance of winning had been 1 in 400. However, machines offering this chance of winning, called MAX machines, paid more balls to winners than machines offering higher chances of winning. These high risk – high return machines were popular among many pachinko players. The new regulations raised the lowest chance of winning to 1 in 300.

Breakdown of machines by chance of winning, Dynam Japan Holdings versus industry



Source: prepared by FISCO from Company materials

Many pachinko players find thrills in playing high risk – high return games. The industry's new regulations make machines that had previously been considered middle risk – middle return the highest possible risk – return combination. Some operators of pachinko halls fear that this lowering of acceptable risk may motivate more pachinko players to stop playing. Only about 15% of the Company's machines are of the MAX type, compared with about 22% for the industry. Conversely, about 61% of the Company's machines offer a 1 in 100 chance of winning, while about 41% of industry machines carry this low risk. As the Company's business is less reliant on high-risk machines than the industry, we estimate that the Company should be less adversely affected by the new regulations than the industry.

However, the Company is being affected by a problem impacting the entire industry, a lack of machines to replace the machines with a 1 in 400 chance of winning. The replacement machines most in demand are those offering a 1 in 300 chance of winning, but there are not enough such machines to meet demand, so deliveries are greatly behind schedule. Under these conditions, hall operators have to be circumspect about their machine purchases. If they carelessly purchase unpopular machines, they may not generate a return on their investment. Furthermore, purchases now may be duplicated in the future. As a result of these circumstances, hall operators cannot procure pachinko machines and must postpone the opening of new halls.

The Company opened three new halls in April 2016, but it expects to freeze new openings for the rest of this calendar year. Therefore, we believe that the 39 halls acquired with Yume Corporation are much more important than the Company had originally foreseen.

The pachinko hall industry is also concerned about a possible acceleration of the rate at which pachinko players are abandoning the pastime as a result of the new regulations. Hit pachinko machines attract a large range of users, from beginners to veterans. Some of these hit machines are of the type that offer a 1 in 400 chance of winning and are therefore scheduled to be replaced. In March 2016, the Japan Game Machine Industrial Association announced the second list of machines to be replaced. This list included the "CR Super Umi Monogatari IN Okinawa 3HME" machine. About 76,000 machines of this model are installed in Japan, and they are very popular. The association plans to announce two more lists of machines to be replaced. If these lists include very popular models, it may become more difficult to operate pachinko halls profitably. This problem will probably not be resolved through the efforts of individual halls.

(4) Impact of Kumamoto earthquake and the Company's response to it

The Company operates 13 pachinko halls in Kumamoto Prefecture. As a result of the strong earthquake that hit this prefecture in mid-April 2016, the company temporarily closed five of these 13 pachinko halls. However, no halls were substantially damaged and no people in the halls were hurt.

From April 18, the Company gradually re-opened the closed halls, and all are now operating normally, while many competing halls in the area are still closed. The Company could reopen its halls quickly because infrastructure in the area was restored rapidly and because the Company's halls are one-story wooden structures, which are highly resistant to earthquake damage. Considering the likelihood of earthquakes in Japan, this type of hall construction should be a competitive advantage for the Company.

The Company assisted people who were forced from their homes by the earthquake in several ways. It opened the parking lots of its halls to cars in which these refugees were living, it built temporary toilets for these people, and it supplied food and water for them.

Result trends

FY3/16 sales increased slightly but profits declined

(1) FY3/16 Results

In FY3/16, the Company's consolidated operating revenue grew 0.9% YoY to ¥155,911mn, while its operating profit declined 6.1% to ¥18,166mn, its pretax profit fell 10.8% to 17,403mn, its net profit attributable to owners of the Company dropped 6.7% to ¥10,544mn, and its EBITDA edged down 0.5% to ¥30,494mn. The Company had not released forecasts for the year. Based on the Company's results in the first half of FY3/16, FISCO had projected full-term consolidated operating revenue of ¥158bn and operating profit of ¥16.5–17.0bn.

Summary of the FY3/16 results

(Unit: ¥mn)

	FY3/15		FY3/16						
	1H	Full year	1H	YoY	Full year	YoY	Yume Corp. contribution	DYJH real value	YoY
Ball rental fee revenue	425,297	826,072	417,104	-1.9%	844,885	2.3%	29,297	815,588	-1.3%
Cost of prizes	344,615	671,516	341,261	-1.0%	688,974	2.6%	23,594	665,380	-0.9%
Operating revenue	80,682	154,556	75,843	-6.0%	155,911	0.9%	5,703	150,208	-2.8%
Operating profit	16,067	19,344	7,383	-54.0%	18,166	-6.1%			
Profit before income taxes	14,729	19,518	7,323	-50.3%	17,403	-10.8%			
Profit attributable to the owners of the parent	9,040	11,303	4,784	-47.1%	10,544	-6.7%			
EBITDA	21,522	30,637	13,170	-38.8%	30,494	-0.5%			

Source: prepared by FISCO from Company materials

Since the Company acquired Yume Corporation on November 1, 2015, the new subsidiary contributed to the Company's consolidated results for the final five months of FY3/16. During these five months, Yume Corporation generated ball rental fee revenue of ¥29,297mn and operating revenue of ¥5,703mn. Excluding these contributions from Yume Corporation, the ball rental fee revenue and operating revenue of Dynam Japan Holdings decreased YoY, amplifying the impact of the shrinking industry.

Consolidated ball rental fee revenue, or gross revenue, grew 2.3% YoY to ¥844,885mn in FY3/16. Excluding the contribution of Yume Corporation, gross revenue fell 1.3% YoY, but we estimate that gross revenue in the industry dropped by more than 1.3%. The consolidated cost of prizes rose 2.6% YoY, but excluding the cost for Yume Corporation, this cost declined 0.9% YoY. Excluding the impact of Yume Corporation, the Company's ball discharge rate, i.e., the cost of prizes relative to ball rental fee revenue, rose to 81.6% in FY3/16 from 81.3% in FY3/15. This rise was intentional and was aimed to attract customers, but it lowered the gross profit margin, which is the ratio of operating revenue to ball rental fee revenue. Despite lifting its ball discharge rate slightly, with the contribution of Yume Corporation, the Company raised its consolidated operating revenue or net sales by 0.9% YoY to ¥155,911mn in FY3/16 even though the number of customers in the pachinko hall industry did not fully recover.

Although the Company controlled the costs of personnel and machines for its halls, it incurred costs for the consolidation of Yume Corporation. Therefore, its total operating costs grew by 2.7% YoY in FY3/16 to ¥138,326mn, and its operating profit fell by 6.1% to ¥18,166mn. The Company stresses EBITDA, which is about equivalent to operating profit plus the costs of depreciation and amortization, as its main measure of profit. In FY3/16, its EBITDA declined by only 0.5% YoY to ¥30,494mn, basically in line with its EBITDA in FY3/15.

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(2) FY3/17 Prospects

The Company does not publish forecasts, so we have estimated its likely results in FY3/17.

The consolidation of Yume Corporation in the last five months of FY3/16 enabled YoY increases in consolidated revenue that fiscal year. In FY3/17, Yume Corporation will contribute seven more months of business results to consolidated results than it did in FY3/16. Based on the revenue posted by Yume Corporation in the final five months of FY3/16, we calculate that it should contribute about ¥7.5bn more to consolidated operating revenue in FY3/17 than it did in FY3/16.

We and the Company expect the operating environment in Japan's pachinko hall industry to remain challenging in FY3/17. Due to the impact of the new industry regulations on high-risk machines, the numbers of new halls opened by the industry and the Company are likely to fall substantially YoY in FY3/17. Therefore, rental ball fee revenue could be eroded by a decline in the number of pachinko players. Industry-wide sales (rental ball fee revenue) fell by an average rate of 3.8% in the nine years from 2005 to 2014.

Since the Company has been shifting its business towards an increased weighting in halls charging low ball rental fees for several years, and since the Company's business does not rely heavily on high-risk machines, we estimate that the Company's consolidated ball rental fee revenue, including five months of contribution from Yume Corporation, should decline by 3% YoY from ¥844,885mn in FY3/16 to ¥819,538mn in FY3/17. We foresee a 3.8% YoY decline in industry-wide ball rental fee revenue in FY3/17. Assuming that the gross profit margin (1 - ball discharge rate) remains 18.5% in FY3/17, unchanged YoY, consolidated operating revenue based on five months of contribution from Yume Corporation would come to ¥151,614mn. Adding our estimate of an additional ¥7.5bn of operating revenue from an additional seven months of contribution from Yume Corporation yields FY3/17 consolidated operating revenue of ¥159,114mn, up 2.1% YoY.

Simulation of FY3/17 operating revenue

Factors	Calculation method	Figure	Remarks
FY3/16 ball rental fee revenue	A	844,885	Includes 5 months of results by Yume Corporation
Rate of growth in industry-wide ball rental fee revenue		-3.8%	The average annual rate of decline from 2005 to 2014
Rate of growth in the Company's ball rental fee revenue including 5 months of contribution by Yume Corporation	B	-3.0%	Reflects shift of business to low playing cost halls and to lower-risk machines
FY3/17 ball rental fee revenue	C=A×B	819,538	Includes 5 months of contribution by Yume Corporation
Assumed gross profit margin for FY3/17	D	18.5%	Unchanged from FY3/16 gross profit margin
FY3/17 operating revenue forecast	E=C×D	151,614	Includes 5 months of contribution by Yume Corporation
Additional contribution to operating revenue from Yume Corporation	F	7,500	7 months of contribution, in addition to the 5 months of contribution in FY3/16
Forecast of FY3/17 operating revenue	G=E+F	159,114	Based on the consolidation of Yume Corporation for 12 months

Source: prepared by FISCO

Yume Corporation will contribute to higher operating costs in FY3/17, but the Company should enjoy larger merits of scale from operating almost 450 halls, it will continue to operate at low cost, and it does not plan any major hall renewals in FY3/17. Therefore, we believe that the Company can maintain its FY3/16 operating profit margin of 11.7% in FY3/17.

Thus, we project a slight YoY rise in operating profit in FY3/17. However, the replacement of high-risk pachinko and pachinko slot machines as required by the industry's new regulations is scheduled to continue through 1H FY3/17, and we cannot predict the total impact of this replacement on the number of pachinko hall customers. If this number were to fall significantly, the Company could suffer profit declines in FY3/17.

■ Result trends

Simplified income statement and the major indicators

(Unit: ¥mn)

	FY3/14	FY3/15			FY3/16		
		1H	2H	Full year	1H	2H	Full year
Ball rental fee revenue	922,172	425,297	400,775	826,072	417,104	427,781	844,885
YOY	-0.8%	-9.6%	-11.3%	-10.4%	-1.9%	6.7%	2.3%
Cost of prizes	756,418	344,615	326,901	671,516	341,261	347,713	688,974
YOY	-1.1%	-11.3%	-11.2%	-11.2%	-1.0%	6.4%	2.6%
Operating revenue	165,754	80,682	73,874	154,556	75,843	80,068	155,911
YOY	1.1%	-1.8%	-11.6%	-6.8%	-6.0%	8.4%	0.9%
Operating costs	135,940	64,791	69,868	134,659	68,855	69,471	138,326
YOY	1.5%	-4.1%	2.2%	-0.9%	6.3%	-0.6%	2.7%
SGA costs	4,086	2,383	3,073	5,456	2,738	3,060	5,798
YOY	31.3%	68.8%	14.9%	33.5%	14.9%	-0.4%	6.3%
Other income	7,139	3,549	3,301	6,850	3,644	4,540	8,184
YOY	-22.8%	16.5%	-19.4%	-4.0%	2.7%	37.5%	19.5%
Other expenses	1,132	990	957	1,947	511	1,294	1,805
Operating profit	31,735	16,067	3,277	19,344	7,383	10,783	18,166
YOY	-7.4%	0.5%	-79.2%	-39.0%	-54.0%	229.1%	-6.1%
Financial income	3,660	1,028	1,123	2,151	275	36	311
Financial expenses	781	2,366	-389	1,977	335	739	1,074
Profit before income taxes	34,614	14,729	4,789	19,518	7,323	10,080	17,403
YOY	3.5%	-8.7%	-74.1%	-43.6%	-50.3%	110.5%	-10.8%
Tax expenses	13,377	5,693	2,566	8,259	2,539	4,325	6,864
Net profit	21,237	9,036	2,223	11,259	4,784	5,755	10,539
YOY	1.5%	-12.1%	-79.7%	-47.0%	-47.1%	158.9%	-6.4%
Profit attributable to the owners of the parent	21,255	9,040	2,263	11,303	4,784	5,760	10,544
YOY	-1.6%	-12.4%	-79.3%	-46.8%	-47.1%	154.5%	-6.7%
EBITDA	42,702	21,522	9,115	30,637	13,170	17,324	30,494
YOY	0.9%	1.3%	-57.5%	-28.3%	-38.8%	90.1%	-0.5%
EPS (¥)	28.6	12.2	3.0	15.2	6.4	7.5	13.9
Dividend per share (¥)	14.00	7.00	7.00	14.00	7.00	6.00	13.00
Operating profit margin	19.1%	19.9%	4.4%	12.5%	9.7%	13.5%	11.7%

Balance sheet

(Unit: ¥mn)

	FY3/14	FY3/15	FY3/16
Current assets	50,946	48,723	43,240
Cash and deposits	34,836	29,239	28,134
Sales receivable	563	486	459
Other	15,547	18,998	14,646
Fixed assets	135,223	132,213	145,944
Tangible fixed assets	94,605	99,961	109,532
Intangible fixed assets	1,408	1,029	3,991
Other	39,210	31,223	32,421
Total assets	186,169	180,936	189,184
Current liabilities	34,910	31,380	30,838
Accounts payable and other debts	19,049	20,468	17,786
Short-term borrowings, etc.	1,265	3,160	2,369
Other	14,596	7,752	10,683
Non-current liabilities	9,249	14,503	25,727
Long-term borrowings	3,059	9,160	18,394
Other	6,190	5,343	7,333
Equity attributable to the owners of the parent	141,990	135,077	132,645
Share capital	15,000	15,000	15,000
Capital surplus	10,129	10,129	12,883
Treasury stock	-	-	-289
Retained earnings	110,136	111,037	110,253
Other components of equity	6,725	-1,089	-5,202
Non-controlling interests	20	-24	-26
Total equity	142,010	135,053	132,619
Liabilities & net worth	186,169	180,936	189,184

Cash flow statement

(Unit: ¥mn)

	FY3/12	FY3/13	FY3/14	FY3/15	FY3/16
Net profit before income taxes	28,404	33,436	34,614	19,518	17,403
Depreciation costs	10,804	10,507	10,234	10,340	11,597
Others	-7,302	-15,613	-17,463	-16,442	-4,927
Cash flow from operations	31,906	28,330	27,385	13,416	24,073
Increase in fixed assets	-7,471	-10,723	-9,292	-16,008	-12,613
Others	18,469	-176	-13,098	-1,005	1,960
Cash flow from investments	10,998	-10,899	-22,390	-17,013	-10,653
Cash flow from financial activities	-31,840	-8,028	-13,102	-2,898	-15,212
Effects of exchange rate changes on cash and cash equivalents	0	3,539	1,477	898	687
Change in cash and cash equivalents	11,064	12,942	-6,630	-5,597	-1,105
Cash and cash equivalents at the beginning of FY	17,460	28,524	41,466	34,836	29,239
Cash and cash equivalents at the end of FY	28,524	41,466	34,836	29,239	28,134

Return to shareholders

The Company will buy back some of its outstanding shares to enhance shareholder returns

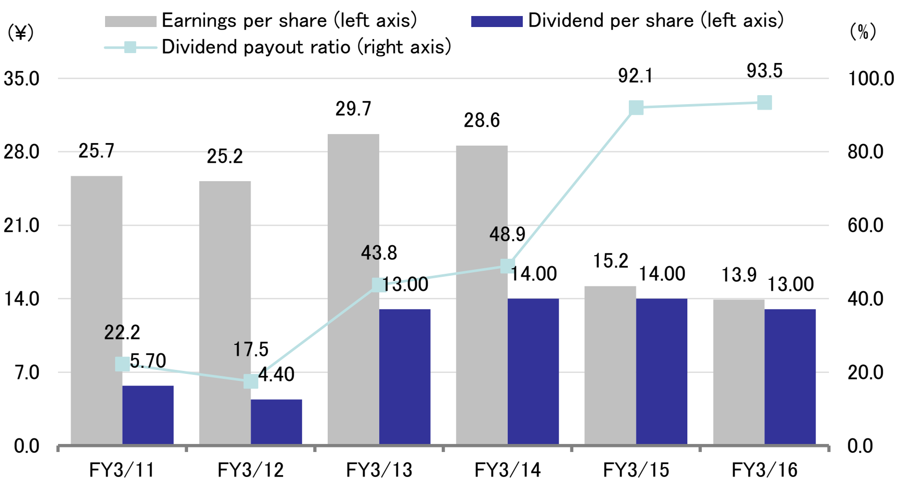
(1) Dividends

The Company is highly conscious of the importance of returns to shareholders and its basic policy is to pay dividends targeting a dividend payout ratio of 35% or above.

It has decided to pay a dividend per share of ¥7 as the interim dividend at the end of FY3/16 Q2. This will mean a dividend payout ratio of 108.7%, so we consider that supported by a high shareholders' equity ratio of 73.0% and ample retained earnings of ¥109,964mn, the Company has decided to prioritize dividend stability.

The Company paid year-end dividends of ¥6 per share for FY3/16, or ¥1 per share less than its interim dividends. Thus, its total dividends for FY3/16 amounted to ¥13 per share. Nonetheless, this full-year dividend was 93.5% of its consolidated earnings per share for FY3/16 of ¥13.9. The Company did not disclose its reasons for paying smaller dividends for FY3/16 than it paid for FY3/15, but we suspect that it aimed to balance its total dividend payment with its net profit for the year. In any case, the Company intends to continue to pay stable dividends.

Trends in earnings per share, dividend per share and dividend payout ratio



Source: prepared by FISCO from Company materials

(2) Share buyback

As part of its return to shareholders, the Company bought some of its outstanding shares in FY3/16. As approved by an extraordinary meeting of the board of directors on January 20, 2016, the Company purchased 15,669,800 of its outstanding shares (2% of its total outstanding shares) between February 1 and March 31 at an average price of HK$13.77 (for a total cost of HK$215.8mn) and retired 14,825,600 of these shares. The Company intends to buy more of its outstanding shares in the future to improve its capital efficiency and boost its share price.

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