COMPANY RESEARCH AND ANALYSIS REPORT

Dynam Japan Holdings

06889

Hong Kong Stock Exchange

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Index

Summary

Healthy progress in cultivation of "DYNAM fans" with focus on customers

Dynam Japan Holdings Co., Ltd. (HK06889) is one of Japan's largest operators of pachinko halls with the largest number of halls operated. 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.

1. Posted lower profits on increased sales in FY3/17 in an increasingly difficult business environment, including tougher gambling regulations

The Company reported ¥156,869mn in operating revenue (+0.6% YoY) and ¥15,899mn in operating profit (-12.5%) in FY3/17. Profit declined on slightly higher sales. Sales dropped YoY on a basis adjusted for disparity in the consolidation period for Yume Corporation. This outcome shows an impact on the Company from substantial decline in industry profitability due to the ongoing market shrinkage trend and stricter regulations aimed at curtailing gambling content.

2. Promoting measures that focus on local customers to expand hall sales in the growth strategy

The Company is promoting operations that focus on local customers to expand hall sales. Its efforts encourage customers to come to its halls by appealing to their feelings, rather than emphasizing facilities and other aspects. Positive results have clearly surfaced thus far. While trends differ depending on the particular hall, the Company is sharing examples of successful halls with other halls in the hope of getting them to incorporate portions that offer useful reference and thereby raising total sales. On the cost front, it is reviewing the hall-opening model and cutting machinery costs by reinforcing development of private brand (PB) machines.

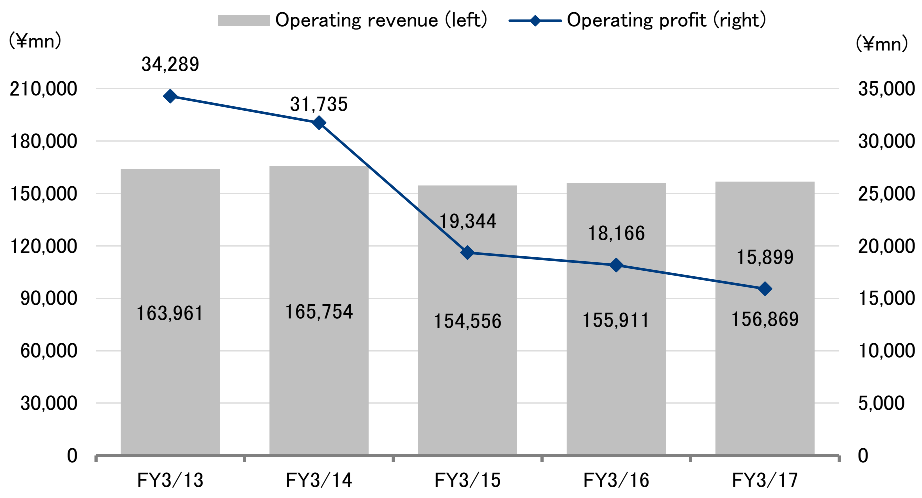
3. Leveraging four strengths to prepare for future industry reorganization and new business initiatives

We think the Company possesses four main strengths – 1) top hall volume in Japan, 2) low-cost operations, 3) customer-oriented management, and 4) large fund-raising capabilities. It should be capable of participating as a buyer in anticipated large-scale industry reorganization by leveraging these strengths. Furthermore, we expect these strengths to make important contributions to success if it pursues new businesses besides pachinko.

Key Points

- Possesses a robust business foundation and achieves differentiation from other firms through interaction of four strengths (top hall volume in Japan, low-cost operations, customer-oriented management, and fund-raising capabilities)
- Places emphasis on operations that focus on local customers; realizing clear results and aims to raise overall sales by sharing success examples
- Capable of restoring sales and profit growth through implementation of measures to attract customers and rigorous low-cost operations

Trend in operating results



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

Company profile

Steadily expanding business with revolutionary measures based on chain store theory and became the first industry firm to be listed on a stock market

1. History

Yohei Sato, the father of Yoji Sato, a current Senior Corporate Advisor, founded Sawa Shoji Co., Ltd. in 1967. Yoji Sato, the eldest son who was working at The Daiei, Inc. at the time, took over the business in 1970 when his father passed away, and steadily expanded operations.

The Company was a pioneer in the pachinko hall industry by acting on new initiatives ahead of peers, including hiring new university graduates, suburban halls and low-cost halls, forming a labor union, and beginning low-fee ball rental. Yoji Sato was an important factor in the Company's adoption of a progressive corporate culture. He joined Daiei due to interest in "chain store theory" that was still a novel concept in Japan. He subsequently managed the Company after the death of his father, who was the founder, and expanded business by consistently applying chain-store theory to pachinko hall operations. Chain store theory is the source of low-cost operations, the Company's largest strength.

His logical approach rooted in chain store theory took hold as the corporate culture and served as a fundamental force lifting Dynam to the position of being the top industry firm. The Company also moved quickly in embracing the most important concepts for modern management of a customer-first ethos, information disclosure, and compliance, providing a foundation for its listing on the Hong Kong Stock Exchange in August 2012.

Company history

Date	History
July 1967	Founded Sawa Shoji Co., Ltd. (opened the Kameari and Kanamachi halls)
November 1987	Renamed as DYNAM Co., Ltd.
April 1989	First group of new university graduates entered the firm
October 1993	Became a corporate member of the Pegasus Club, an organization that analyzes chainstore operations.
August 1994	Opened the Company' s first low playing cost pachinko hall made of wood in Ebetsu, Hokkaido.
July 1997	Held the Company's first business results briefing with securities analysts.
April 1998	Established the Dynam Union, the first labor union in the pachinko industry
December 2006	Started the first low ball rental fees (pachinko ¥2, slot ¥10) at the Ebetsu hall
December 2006	Established DYNAM JAPAN HOLDINGS Co., Ltd.
September 2011	DYNAM JAPAN HOLDINGS Co., Ltd. is established, as a result of incorporation-type company split from DYNAM Holdings Co., Ltd.
August 2012	Listed shares on the Hong Kong Stock Exchange
January 2013	Incorporated the Hong Kong entity, Dynam Hong Kong Co., Limited
June 2013	Announced an investment of $35mn in Macau Legend Development Limited
October 2013	Announced an investment of $15mn in IGG Inc.
November 2015	Consolidated Yume Corporation Co., Ltd.

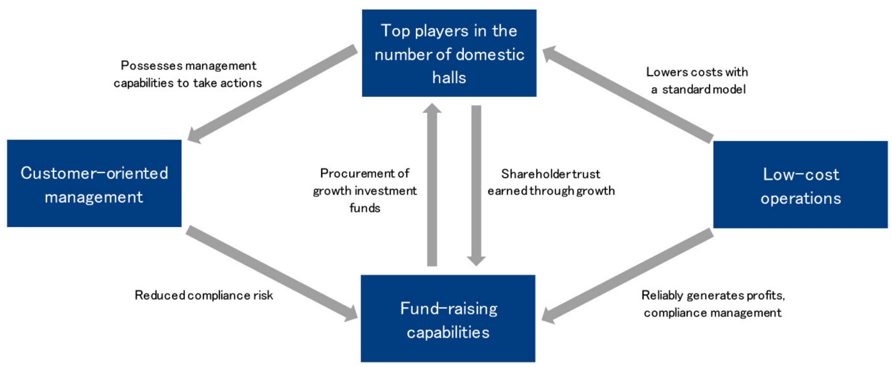
Source: Prepared by FISCO from the Company's website and securities report

Possesses a robust business foundation and achieves differentiation from other firms through interaction of four strengths

2. Dynam Group's features and strengths

We focus on four points as the Company's attributes and strengths – 1) top hall volume in Japan, 2) low-cost operations, 3) customer-oriented management, and 4) fund-raising capabilities. Importantly these strengths are mutual interactive. We think it is difficult for other firms to realize the same combined strength seen at the Company.

Relationship among the four strengths of the DYNAM Group



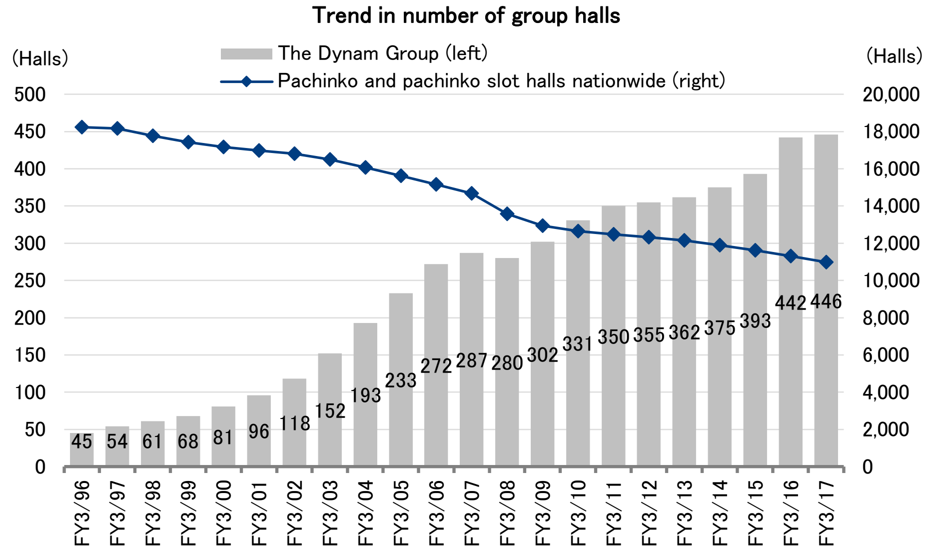
Source: FISCO Inc. from contact

(1) Top hall volume in Japan

The Company has the largest number of halls in the industry with 446 halls as of the end of March 2017 and holds a 4% domestic share in machine volume.

Economies of scale are a valuable benefit of having a large number of stores (scale merit). They extend to new hall openings, renovations, machine deployment, gift procurement, and logistics and others. Machine deployment is particularly important. The large number of halls naturally means having many pachinko and pachinko slot machines, thereby enhancing buying (price negotiating) power with equipment firms.

Benefits at Yume Corporation, which entered the group in November 2015, offer a specific example of scale merit. Yume Corporation reduced costs by a total of about ¥700mn (on an annualized basis) after joining the group in items such as amusement equipment purchases, logistics, and financing costs. The savings corresponds to 12% of Yume Corporation's previous costs.

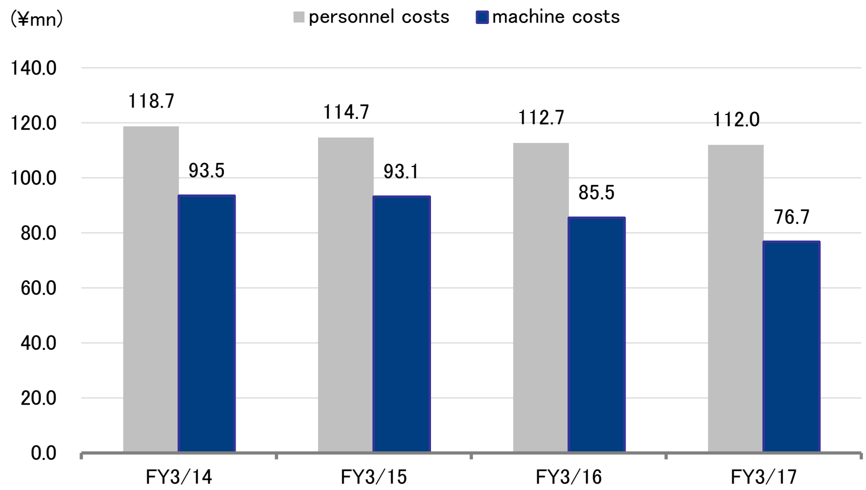


Source: Prepared by FISCO from the Company's results briefing materials

(2) Low-cost operations

Low-cost operations are a vital source of the Company's competitiveness. Our understanding is that this aspect enables the Company to realize and benefit from various measures, including growth strategies. Chain store theory provides the theoretical backdrop to low-cost operations. Costs of personnel and machines constitute a large portion of the total cost of operating a pachinko hall. Yet it takes more than just direct cost cutbacks. The Company is succeeding with low-cost operations as an overall group by deploying hall designs and hall operating systems that facilitate operations with a small number of employees and by standardizing new halls. Chain store theory plays an important role in a variety of ways and is enabling low-cost operations as a group.

Trend in personnel costs and machine costs per hall



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

The Company is the industry leader in Japan, as mentioned earlier, with 446 halls. Aggressive multi-site operations support this position and low-cost operation knowhow has been an essential enabler. Additions to hall volume created a virtuous cycle of cost reductions through scale merit that has put the Company in its strong position. We think customer-oriented management explained below is an outcrop from low-cost operations as well.

The history section explained the background to the Company's utilization of chain store theory in its management. The Company established the Pachinko Chain Store Association (PCSA), an industry group, with peers who have a similar view, and this entity has been researching application of chain store theory to pachinko hall management. PCSA activities have not only contributed to strengthening the business foundation of industry peers, but also played a major role in the Company's expanded scope with the addition of Yume Corporation to the group. There is a possibility of this type of example occurring again.

(3) Customer-oriented management

The Company advocates a "customer-first" approach as one of its five business policies and has been taking action. This stands out because we think few peers who promote similar policy are actually carrying through in actions.

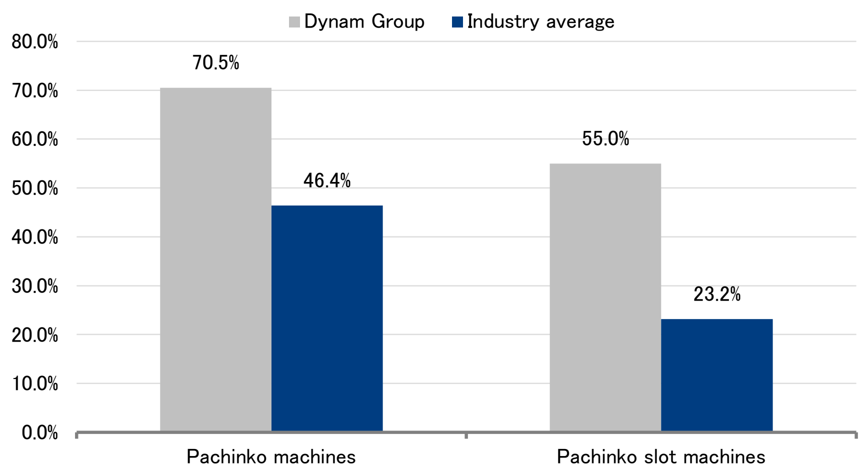
Our understanding of "customer-oriented management" is implementing measures for co-existence and co-prosperity between customers and halls. We have a favorable view of the Company's "low ball rental fees" and "operations that do not rely on gambling appeal" among its business policies. The Company has defined pachinko as a "time-using leisure" activity for some time and still adheres to this view.

a) Low ball rental fee operations

Pachinko is a game that is played with rented balls. The fee for renting balls (halls lend the balls) had been ¥4 per ball. Low ball rental fee operations takes a cheaper approach that lowers the fee to ¥1 or ¥2. Customers can rent more balls for the same fee, extending their playing time in accordance with the additional balls. The Company has been aggressively opening halls with low ball rental fee formats, which install a high ratio of low-fee ball machines, and increasing installation of low ball rental fee machines at existing halls too. Its low ball rental fee machines currently account for 70.5% of pachinko machines and 55.0% of pachinko slot machines, substantially exceeding the industry averages (from end-December 2016).

Data shows that the Company's halls offering low ball rental fees have attracted more customers than its halls charging higher fees. Yet it takes substantial company wherewithal in order to adopt this type of strategy because margin declines at halls with low ball rental fees owing to weaker revenue than halls charging higher fees without much difference in operating costs. A measure to offset this aspect is growth through expansion of hall volume. The Company has truly followed this path.

Comparison of low ball rental fee machines
(as of the end of December 2016)



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

b) Operations that do not rely on gambling appeal

As specified, the Company does not position models with strong gambling content as a central strategy. It offers a wide range of pachinko machines from ones with high probability of major winds to ones with low probability. Machines with lower probability give a larger number of balls in a major win and are preferred by pachinko fans. Many pachinko halls hence attract customers by operating halls with an elevated ratio of machines that have low major-win probability (in order words, machines with strong gambling features).

However, authorities introduced regulations to curtail gambling content in FY3/17, lifting the minimum probability threshold from 1/400 to 1/320. This change led to a clear loss of customers. While more details are given below, regulations on gambling content are unlikely to end at 1/320 and we expect continuation of regulatory reinforcement. These conditions might result in further customer decline at halls relying on machines with strong gambling appeal.

The Company, meanwhile, has a lower ratio of gambling-type machines than the industry and the share of machines with the lowest gambling features at 1/100 probability conversely is 20pp higher than the industry average. We expect some impact on the Company from stricter regulations on gambling as well, though the impact should be relatively modest based on its machine composition.

(4)Fund-raising capabilities

The Company became the first company in the pachinko hall industry to list its shares with its IPO on the Hong Kong Stock Exchange in 2012. Only two companies, including the Company, out of the pachinko hall industry's roughly 3,500 firms are listed on stock markets. The industry is projected to face reorganization going forward. An important point for a buyer in this environment is obviously whether it has fund-raising capabilities.

The Company capitalized on its strength as a listed company to acquire Yume Corporation in November 2015 through a stock swap for all of the shares. We anticipate very strong benefits for the Company as a listed company in non-M&A areas too because of likely need for a variety of funds in the future for casino and resort developments and other initiatives.

Growth strategy

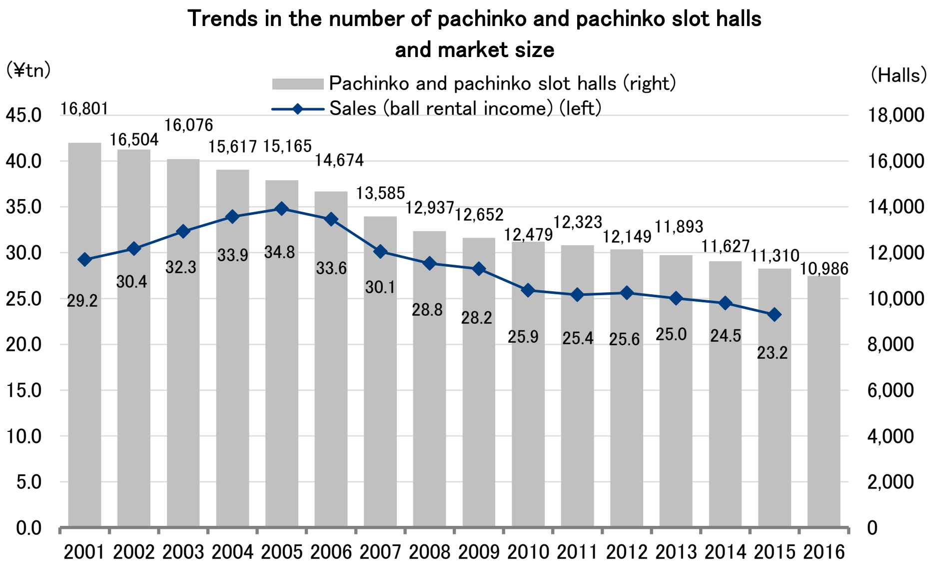
Market shrinkage remains an issue, plus regulatory reinforcement aimed at curtailing gambling and addiction countermeasures are new challenge

1. View of the industry environment

(1) Pachinko and pachinko slot hall industry continue to shrink

The pachinko and pachinko slot playing population appears to be bottoming out with the recovery above 10mn in 2014 and 2015 after dropping to 9.7mn in 2013. Market size (total value of ball rental fee revenue that corresponds to gross pachinko hall revenue), however, declined 5.2% YoY to ¥23,229bn in 2015.

The number of pachinko and pachinko slot halls nationwide has also been steadily dropping due to ongoing market contraction. The number of halls has been falling at a pace of 200-300 halls per year over the last few years and was down by 324 halls from the previous year to 10,986 halls as of December 2016 (National Police Agency data). This is the lowest level in 20 years.



Source: Prepared by FISCO from Japan Productivity Headquarters' "White Paper on Leisure" and National Police Agency data

The causes of the shrinkage in the pachinko market vary with time, but in recent years the proliferation of smartphones is believed to have been a major factor. The segment using free time at pachinko halls has started putting time toward smartphones.

We think smartphone proliferation is affecting efforts to attract new users, mainly younger people. The pachinko playing population hence is shrinking, and this is contributing downturn in market size.

(2) Growing efforts to curtail gambling and addiction countermeasures

The pachinko industry confronts regulations from supervisory agencies and industry groups that extend from equipment firms to hall operators. In FY3/17, industry regulations were strengthened to curtail the gambling aspect of pachinko play.

The gambling feature is expressed in terms of the probability of a major win for a specific machine. Machines with lower probability pay a larger number of balls for major wins. Pachinko machines had been grouped into 1/100, 1/200, 1/300, and 1/400 (MAX machines) types with the 1/400 machines offering the strongest gambling appeal. However, voluntary regulatory efforts by the pachinko industry resulted in removal of 1/400 machines by the end of December 2016.

Pachinko fans generally prefer machines with higher gambling content, and these machines were the most profitable for pachinko halls. Voluntary regulations moved the 1/300 type (the actual upper limit is 1/320) in the top position. Loss of pachinko fans, even temporarily, pressures earnings in the pachinko hall industry.

Nevertheless, regulations on gambling are unlikely to stop at the current level and should proceed further. Our view takes into account the Act on Promoting Development of Areas for Specified Integrated Resort Facilities (Casino Act) passed in December 2016. The current Act is a program law that defines the purpose of integrated resort promotion and basic policies, and specific legal rules will be presented in the implementation act that still needs to be formulated. The Government plans to formulate this act during 2017 and has established a "council of related ministers for promotion of gambling and other addiction countermeasures" to discuss matters. One of the council's topics is curtailment of the gambling content of pachinko and pachinko slot machines.

Reduction of gambling appeal has a negative impact at least initially on pachinko hall businesses, as mentioned earlier. The Company has relative advantages over other firms because of its operations that do not rely on gambling, though there is still some impact on income. A key point is how to transform the decline in gambling content into an opportunity for earnings growth. Additionally, authorities are calling on hall operators to conduct addiction countermeasures and we expect costs related to these efforts to be an issue as well.

Places emphasis on operations that focus on local customers; realizing clear results and aims to raise overall sales by sharing success examples

2. The Company's initiatives

(1) Top-line growth initiatives

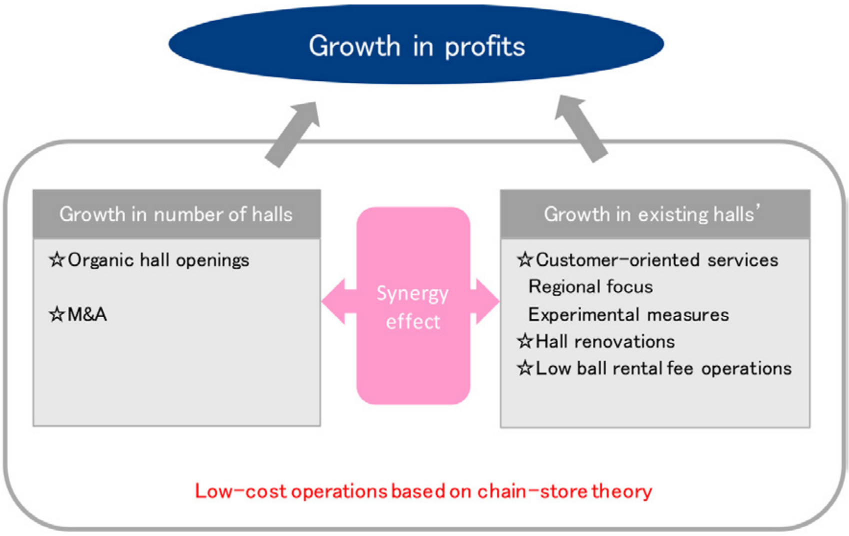
The Company carried out large-scale renovations of halls aimed at boosting customer volume and sales during 4Q FY3/15 to 1Q FY3/16. It hopes to expand hall sales from FY3/17 and has started new challenges. Efforts include operations that focus on local customers and experimental measures at some halls. Operations that focus on local customers promote development of halls from a customer perspective in light of local customer attributes. The Company uses this approach at all of its halls. Experimental measures select two halls as experimental sites and take actions that go beyond the conventional pachinko hall framework. The Company intends to roll out measures that work well to other sites.

While past initiatives utilized uniform content for all halls, such as hall renewals and other equipment and facility revisions, the latest stance differs significantly because it focuses on customers as individuals and aims to cultivate entrenched fans by appealing to customer sentiment. Furthermore, headquarters does not intend to drive these measures in a top-down manner. Emphasis is being given to measures that fit the unique features of individual halls (such as location and customer segments). This means that the capabilities of hall managers and other local staff are likely to strongly influence results.

We felt the concept underlying this initiative was very convincing so had been looking for some effect. Our review of the effect at a few tens of halls in the initial fiscal year (FY3/17) indicates that it is having clear benefits. While there is variation among individual halls, the Company is sharing examples from successful halls with other halls in the hope of getting them to incorporate portions that offer a useful reference and thereby raising total sales. Given the thrust of the Company's policy of "focus on local customers," the point is sharing best practices among halls, rather than headquarters taking the lead in requiring implementation of uniform measures.

The Company could solidify a growth strategy with two main components, including its existing expansion of hall volume, if it successfully revives sales at existing sites through this new challenge. Up until now, the Company had been pursuing growth in overall sales by utilizing expansion of hall volume to offset the negative trend of "market shrinkage causing decline in hall sales." We think a two-pronged growth strategy that adds growth in same-site sales is clearly much more resilient.

Image of two growth strategies – hall network expansion and existing halls' revenue gains



Source: Prepared by FISCO from interviews

(2) Initiatives for cost reductions

The Company is also actively promoting initiatives to lower costs. While it prepares a standard model for new hall openings, this approach has been slightly modified. It retains the same hall concept, location, and standard size features. However, the number of machines has been changed from 480 machines to 512 machines. The previous format created islands of 40 machines that consist of two rows of 20 machines and placed 12 islands per hall. The new model, meanwhile, utilizes an island of 32 machines (two rows of 16 machines) and arranges 16 islands. This revision has two main aims. One is lowering costs for new machine replacement by shrinking the island unit to 32 machines. The other is boosting market share on an installed machine basis with the increase in machine volume and thereby bolstering buying power.

Furthermore, the Company is making steady progress in development of private-brand (PB) pachinko machines. Cost benefits from previous P/B machines had been limited because they mainly involved adjustments to the surface design. Recent efforts, however, have expanded to self-design from the board level, substantially expanding cost benefits. We expect these measures to contribute to earnings because machine costs occupy a high percentage of pachinko hall operations, along with personnel expenses.

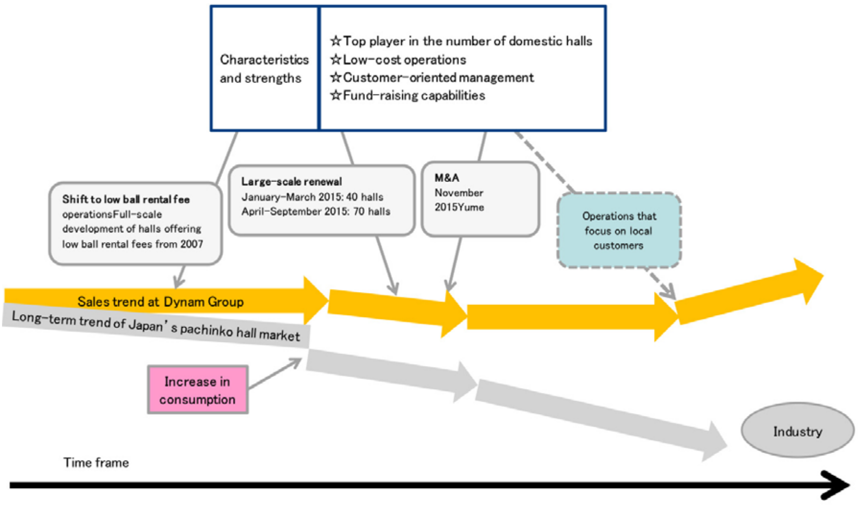
(3) Long-term growth strategy

The Company has maintained a consistent approach in its long-term growth strategy over the years. While the pachinko hall industry continues to face tough business conditions, this environment also offers a growth opportunity.

The downward trend in the pachinko hall industry is not something new and has been evident for at least 10 to even 15 years. The Company understood the shrinkage trend in the industry from early on and steadily took actions to bolster its profitability. These efforts are still paying off for the Company through low-cost operations based on chain store theory, scale merit from the industry-leading hall network, and fund-raising capabilities and other strengths as a listed company. In any industry, challenging market environments can serve as a catalyst for industry reorganization. We think the Company is capable of sustaining the wherewithal to participate in reorganization as a buyer when this happens.

Furthermore, the Company's medium to longer-term growth strategy is not restricted to the pachinko industry. We believe it is naturally reviewing the option of entering businesses besides pachinko. The Company's fundamental tangible and intangible assets, such as the robust financial base and low-cost operations cultivated in the pachinko business, fund-raising capabilities, and compliance management, should pay off at that time.

Conceptual image of DYNAM Group's various measures
and medium to longer-term growth strategy



Source: Prepared by FISCO from interviews

Integrated report

Disclosed an integrated report, enhancing non-financial (ESG) information and provision of tools for dialogue with long-term investors

1. Disclosed an integrated annual report

(1) Response to the ESG information disclosure requirement for companies listed on the Hong Kong Stock Exchange

The Company disclosed an Annual Report for FY3/17 (Annual Report 2017) on May 29. This annual report differs significantly from past disclosure in its expanded coverage of environmental (E), social (S), and governance (G) (ESG) information. The Hong Kong Stock Exchange requires companies with financing reporting from January 2017 to disclose ESG information. Annual reports already needed to give information on corporate governance (G), and the revision extends the obligation to environmental (E) and social (S) initiatives. Efforts to enhance disclosure of non-financial information have been picking up. The Company's latest annual report devotes more than 20 pages to its views on environmental (E) and social (S) matters and related initiatives.

(2) Advancing to corporate reporting based on an integrated mindset

We find it very interesting that the Company's annual report offers more than a simple review of ESG information and presents content targeting sustainable growth over the long term through simultaneous improvement of social value through ESG initiatives and enhancement of economic (financial) value via business activities. This fits well with the concept of "creating shared value (CSV)" advocated by Michael Porter. The impact of pachinko in society cannot be overlooked when the Company assesses its long-term growth. In the section on "risk and opportunity," the Company addresses negative impacts, such as the addiction problem, as business risk that threatens long-term advancement and explains that it intends to properly manage and minimize such risk. Additionally, in positive aspects for resolution of issues in local society, it expresses interest in innovations to realize new business opportunities that support long-term growth. The Company took into account the integrated international reporting framework defined by the International Integrated Reporting Council (IIRC) in structuring its report, as noted in the editing policy at the start of the Annual Report. We think room still exists from a content perspective to delve deeper into the various themes. However, the Company's initiative to identify the value that it creates and proactively disclose information deserves notice as a leading company in the pachinko hall industry.

2. Reinforcement of tools for dialogue with long-term investors

We have a positive view of the disclosure of the integrated report as evidence of willingness to engage in dialogue with global long-term investors. The number of institutional investors from around the world that are signatories to the United Nations' Principles for Responsible Investment (PRI) has been rising, and the value of assets managed by signatory entities totaled just over $62trn in April 2016. Formulation of the stewardship code is further evidence of interest in more dialogue between investors and companies. Pursuit of enhanced enterprise value from a long-term perspective, including ESG, is becoming a common theme for long-term investors and companies. We will be looking for utilization of the Company's annual report as a tool for dialogue with long-term investors. Management plans to newly release a CSR report in July. Steady reinforcement of dialogue tools with long-term investors should broaden opportunities for fair valuation of the Company shares in the stock market.

Results trends

Posted lower profits on increased sales, unable to avoid an impact in an increasingly difficult business environment, including tougher gambling regulations

1. Summary of the FY3/17 results

The Company reported ¥156,869mn in operating revenue (+0.6% YoY), ¥15,899mn in operating profit (-12.5%), and ¥9,360mn in profit attributable to parent owners (-11.2%) in FY3/17. Profit declined on slightly higher sales. EBITDA fell 6.6% to ¥28,469mn.

Summary of the FY3/17 results

(¥mn)

	FY3/15 full year	FY3/16 full year	FY3/17					
			1H	YoY	2H	YoY	Full year	YoY
Ball rental fee revenue	826,072	844,885	416,246	-0.2%	401,531	-6.1%	817,777	-3.2%
Cost of prizes	671,516	688,974	336,438	-1.4%	324,470	-6.7%	660,908	-4.1%
Operating revenue	154,556	155,911	79,808	5.2%	77,061	-3.8%	156,869	0.6%
Total expenses	135,212	137,745	71,600	4.6%	69,370	0.1%	140,970	2.3%
Operating profit	19,344	18,166	8,208	11.2%	7,691	-28.7%	15,899	-12.5%
Profit before income taxes	19,518	17,403	6,635	-9.4%	8,190	-18.8%	14,825	-14.8%
Profit attributable to owners of the parent	11,303	10,544	3,860	-19.3%	5,500	-4.5%	9,360	-11.2%
EBITDA	30,637	30,494	14,431	9.6%	14,038	-19.0%	28,469	-6.6%

Source: Prepared by FISCO from the Company's financial results summary materials and the annual results announcement

Operating revenue only rose 0.6% to ¥156,869mn. We explain the situation in more detail below. Profitability declined further in the pachinko industry in FY3/17 due to tougher regulations on gambling content amid long-term contraction of the market. While the impact on the Company was relatively modest, these industry headwinds still affected the earnings outcome to some extent.

The Company consolidated five months of Yume Corporation's results in 2H FY3/16 following the addition of this entity to the group in November 2015. In FY3/17, the contribution covered a full 12 months and Yume Corporation provided a seven-month lift to operating revenue (¥7,087mn). Operating revenue excluding this portion dropped 3.9% YoY.

The Company had 446 halls at end-FY3/17 because of a net increase of four halls from opening five halls and shutting one hall. In a difficult industry environment, it focused on measures to raise sales at existing sites, rather than investing in new halls. Specifically, it promoted sales activities with a "local focus" that makes adjustments to individual halls to enhance customer appeal by leveraging unique aspects of each site (location and customer segment differences). Benefits started emerging from around the summer and led to a rebound to a YoY increase and widening of disparity with the industry reference value in the number of active gaming machines, a key performance indicator (KPI). This trend has positive implications from FY3/18.

For earnings, the Company reduced personnel and machinery costs, the two largest operating expense items, in its vigorous implementation of low-cost operations. However, the total expenses value, including the others balance, increased 2.3% YoY because of full consolidation of Yume Corporation and operating profit was down 12.5% to ¥15,899mn.

EBITDA (operating profit + depreciation costs, + financial income) slipped 6.6% to ¥28,469mn. Nevertheless, it remains close to ¥30,000mn and the Company has very extensive funding leeway in a situation where it only opens about five new halls a year.

Likely to restore sales and profit gains with measures to attract customers and rigorous low-cost operations

2. Prospects for FY3/18

The Company does not disclose forecast. We think the following estimates for FY3/18 are possible by making certain assumptions.

Ball rental income, which corresponds to gross sales in the pachinko hall business, totaled ¥817,777mn in FY3/17.

It is estimated that pachinko market was worth ¥23.2trn in 2015, which is the total value of ball rental income at industry firms. The market has been declining at a 4.0% average annual pace at the 10 years through 2015 from a starting point in 2005. We expect the overall industry to adhere to this trend line again in FY3/18.

The Company exhibited clear improvements in FY3/17, such as having numerous months with YoY increase in active gaming machine volume owing to customer recruitment strategy with focus on customers as a way of raising sales at existing sites. We anticipate full-fledged manifestation of this effect in FY3/18 and think it is possible to realize a decline rate in ball rental income that is 2pp less than the 4% industry average. Also, the Company opened five halls at the start of the fiscal year and plans to open a hall in December as well. We envision a 1pp lift to ball rental income from the operation of these six halls. Our analysis assumes a 1% decline in ball rental income in FY3/18 based on these points. This puts the estimate of FY3/18 ball rental income at ¥809,599mn.

Operating revenue is obtained by deducting cost of prizes value from ball rental income and hence represents gross profit margin on ball rental income. The Company reported 19.2% gross profit margin in FY3/17. Increasing gross margin implies a drop in the ball put-out ratio (percentage of cost of prizes value in ball rental fee revenue) and raises the risk of customer losses. While the Company takes a cautious stance toward raising gross profit margin (lowering the ball put-out ratio), we forecast a nominal increase in gross margin due to the growing share of low ball rental fee machines and assume 19.5% as the FY3/18 gross profit margin. We project ¥157,872mn in FY3/18 operating revenue based on this gross profit margin and the above-mentioned ball rental fee revenue estimate.

Simulation of FY3/18 operating revenue

Factors		Value	Remarks
The Company's FY3/17 ball rental income (million yen)	(A)	817,777	
FY3/18 industry average ball rental income growth estimate		-4.0%	Average growth rate for pachinko market size (ball rental fee revenue basis) over the 10 years through 2015 with 2005 as the starting point
FY3/18 the Company ball rental fee revenue growth estimate	(B)	-1.0%	Estimated growth rate for the Company's ball rental fee revenue in FY3/18 Reduces the negative margin for the active machine utilization rate growth rate (YoY) by 2pp for consistently higher growth than the industry average and 1pp for the new hall effect (four halls at period-start)
The Company's FY3/18 forecast ball rental fee revenue	(C=A×B)	809,599	
Assumed gross profit margin for FY3/18	(D)	19.5%	Gross profit margin is the percentage of operating revenue in ball rental fee revenue and was 19.2%in FY3/17; expecting a nominal rise in FY3/18 due to the shift to low ball rental fee operations
FY3/18 operating revenue forecast	(E=C×D)	157,872	

Source: Prepared by FISCO from the Company's financial results summary materials, direct contact, and the Japan Productivity Center's "White Paper on Leisure"

For earnings, personnel costs and machinery costs per hall are continuing to trend lower as mentioned earlier. While the Company plans to add six new halls (about 1%) in FY3/18, cutbacks in expenses per hall should be capable of keeping total expenses flat to lower (YoY). Operating profit determined from the above-mentioned operating revenue works to ¥16,902mn (+6.3% YoY) assuming that total cost value is flat.

The pachinko hall business is likely to continue encountering a very tough environment again in FY3/18. However, our simulation described above concludes that the Company is capable of realizing sales and profit gains by implementing measures to attract customers and vigorously engaging in low-cost operations.

Simplified income statement and the major indicators

(¥mn)

	FY3/14	FY3/15	FY3/16	FY3/17		
				1H	2H	Full year
Operating revenue	165,754	154,556	155,911	79,808	77,061	156,869
YOY	1.1%	-6.8%	0.9%	5.2%	-3.8%	0.6%
Hall operating expenses	135,940	134,659	138,326	72,474	69,668	142,142
YOY	1.5%	-0.9%	2.7%	5.3%	0.3%	2.8%
SG&A costs	4,086	5,456	5,798	2,692	2,930	5,622
YOY	31.3%	33.5%	6.3%	-1.7%	-4.2%	-3.0%
Other income	7,139	6,850	8,184	4,676	4,548	9,224
Other expenses	1,132	1,947	1,805	1,110	1,320	2,430
Total expenses	134,019	135,212	137,745	71,600	69,370	140,970
YOY	3.4%	0.9%	1.9%	4.6%	0.1%	2.3%
Operating profit	31,735	19,344	18,166	8,208	7,691	15,899
YOY	-7.4%	-39.0%	-6.1%	11.2%	-28.7%	-12.5%
Financial income	3,660	2,151	311	173	60	233
Financial expenses	781	1,977	1,074	1,746	-439	1,307
Profit before income taxes	34,614	19,518	17,403	6,635	8,190	14,825
YOY	3.5%	-43.6%	-10.8%	-9.4%	-18.8%	-14.8%
Tax expenses	13,377	8,259	6,864	2,815	2,705	5,520
Net profit	21,237	11,259	10,539	3,820	5,485	9,305
YOY	1.5%	-47.0%	-6.4%	-20.2%	-4.7%	-11.7%
Profit attributable to owners of the parent	21,255	11,303	10,544	3,860	5,500	9,360
YOY	-1.6%	-46.8%	-6.7%	-19.3%	-4.5%	-11.2%
EBITDA	42,702	30,637	30,494	14,431	14,038	28,469
YOY	0.9%	-28.3%	-0.5%	9.6%	-19.0%	-6.6%
EPS (¥)	28.60	15.20	13.90	5.04	7.19	12.23
Dividend per share (¥)	14.00	14.00	13.00	6.00	6.00	12.00

Source: Prepared by FISCO from the Company's financial results summary materials and the annual results announcement

Balance sheet

(¥mn)

	End-FY3/14	End-FY3/15	End-FY3/16	End-FY3/17
Current assets	50,946	48,723	43,240	63,072
Cash and deposits	34,836	29,239	28,134	48,499
Sales receivable	563	486	459	563
Non-current assets	135,223	132,213	145,944	142,043
Tangible fixed assets	94,605	99,961	109,532	106,687
Intangible assets	1,408	1,029	3,991	3,833
Total assets	186,169	180,936	189,184	205,115
Current liabilities	34,910	31,380	30,838	38,496
Accounts payable	19,049	20,468	17,786	18,282
Short-term borrowings	1,265	3,160	2,369	7,281
Non-current liabilities	9,249	14,503	25,727	29,738
Long-term borrowings	3,059	9,160	18,394	22,768
Equity attributable to owners of the parent	141,990	135,077	132,645	136,953
Share capital	15,000	15,000	15,000	15,000
Capital surplus	10,129	10,129	12,883	12,741
Retained profits	110,136	111,037	110,253	112,403
Other constituent of equity	6,725	-1,089	-5,202	-3,191
Non-controlling interests	20	-24	-26	-72
Total equity	142,010	135,053	132,619	136,881
Liabilities & net worth	186,169	180,936	189,184	205,115

Source: Prepared by FISCO from the results announcement

Cash flow statement

(¥mn)

	FY3/13	FY3/14	FY3/15	FY3/16	FY3/17
Net profit before income taxes	33,436	34,614	19,518	17,403	14,825
Depreciation costs	10,507	10,234	10,340	11,597	11,895
Others	-15,613	-17,463	-16,442	-4,927	-132
Cash flow from operating activities	28,330	27,385	13,416	24,093	26,588
Increase in fixed assets	-10,723	-9,292	-16,008	-12,613	-9,925
Others	-176	-13,098	-1,005	1,940	3,641
Cash flow from investing activities	-10,899	-22,390	-17,013	-10,673	-6,284
Cash flow from financing activities	-8,028	-13,102	-2,898	-15,212	192
Effects of exchange rate changes on cash and cash equivalents	3,539	1,477	898	687	-131
Change in cash and cash equivalents	12,942	-6,630	-5,597	-1,105	20,365
Cash and cash equivalents at the beginning of FY	28,524	41,466	34,836	29,239	28,134
Cash and cash equivalents at the end of FY	41,466	34,836	29,239	28,134	48,499

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

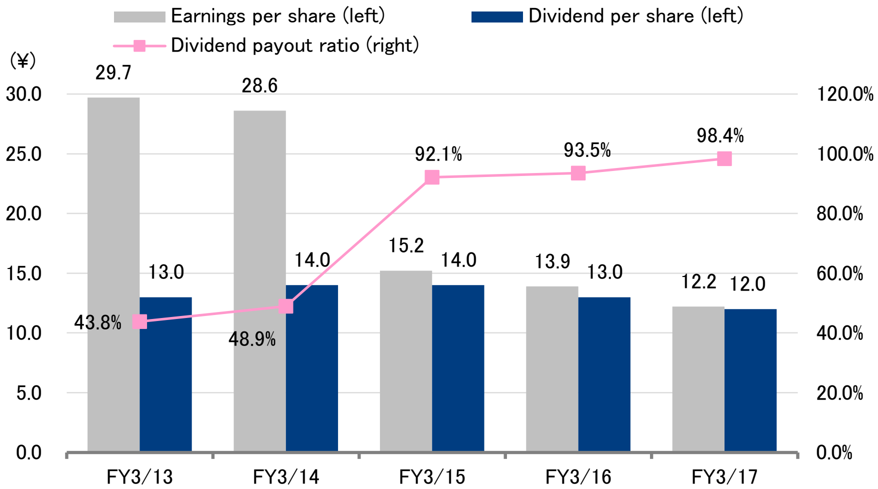
Returns to Shareholders

Decided a ¥6 period-end dividend, putting the full-year dividend at ¥12 in FY3/17

The Company is highly conscious of the importance of returns to shareholders because it recognizes the importance of raising shareholder value in order to achieve sustainable growth. It continues to pay stable dividends based on this view.

The Company decided to pay a ¥6 dividend for the period-end in FY3/17. This puts the full-year dividend at ¥12, including the ¥6 interim dividend. The total annual dividend payment hence amounts to ¥9,192mn and a dividend payout ratio of 98.4%. The Company generated robust EBITDA again in FY3/17 at ¥28,469mn, as explained above. Despite this level, it limited hall investments to five new sites in FY3/17 and only plans six new sites in FY3/18. We think its decision reflects a view that it is retaining the profits it needs for future growth and is also capable of paying sufficient return to shareholders.

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



Source: Prepared by FISCO from financial results summary materials and the results announcement

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